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UTILITY RATEPAYER REFUNDS; INDIAN FISHING RIGHTS; AND UNITED NATIONS HOUSING BENEFITS

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

H.R. 1049

UTILITY RATEPAYER REFUND ACT OF 1987

H.R. 2792

TO CLARIFY INDIAN TREATIES, EXECUTIVE ORDERS, AND ACTS OF
CONGRESS WITH RESPECT TO INDIAN FISHING RIGHTS

AND

TAXATION OF HOUSING BENEFITS FOR INDIVIDUALS EMPLOYED BY
THE UNITED NATIONS

DECEMBER 14, 1987

Serial 100-49

Printed for the use of the Committee on Ways and Means



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**UTILITY RATEPAYER REFUND ACT OF 1987;
INDIAN FISHING RIGHTS/TAX EXEMPTION;
AND TAXATION OF HOUSING BENEFITS FOR
INDIVIDUALS EMPLOYED BY, OR ASSIGNED
TO, THE U.S. MISSION TO THE UNITED NA-
TIONS**

MONDAY, DECEMBER 14, 1987

**HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
*Washington, DC.***

The subcommittee met, pursuant to notice, at 10 a.m., in room 2322, Rayburn House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

[The press releases announcing the hearing, and a copy of the bills H.R. 1049 and 2792, follow:]

(1)

FOR IMMEDIATE RELEASE
TUESDAY, NOVEMBER 10, 1987

PRESS RELEASE #5
SUBCOMMITTEE ON SELECT
REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-9710

THE HONORABLE CHARLES B. RANGEL (D., N.Y.),
CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES,
COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A PUBLIC HEARING ON H.R. 1049,
THE UTILITY RATEPAYER REFUND ACT OF 1987

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a public hearing in the near future on H.R. 1049, a bill introduced by Mr. Dorgan (D., N.D.), et al. A subsequent press release will announce a specific date and further details.

BACKGROUND

The Tax Reform Act of 1986 (the 1986 Act) requires the normalization of excess deferred tax reserves of regulated utility companies resulting from the reduction of corporate income tax rates from 46 to 34 percent. Deferred tax reserves are established on the books of account of utility companies when depreciation allowances are claimed more rapidly for tax purposes than for establishing utility rates. Under the 1986 Act, if an excess deferred tax reserve is reduced more rapidly than such reserve would be reduced under the average rate assumption method, the utility company would be required to use the same depreciation method for tax purposes as it used for purposes of setting rates and reflecting operating results in regulated books of accounts. H.R. 1049 would repeal this provision of the 1986 Act.

The excess deferred tax reserve is defined as the reserve for deferred taxes computed under prior law, less what the reserve for deferred taxes would be if the tax rate in effect under the 1986 Act had been in effect for all prior periods. The average rate assumption method is the method which reduces the excess deferred tax reserve over the remaining regulatory lives of the property that gave rise to the reserve. Under this method, the excess deferred tax reserve is reduced as the timing differences reverse over the life of the asset. Timing differences are differences between tax depreciation and regulatory depreciation with respect to each asset, or group of assets in the case of vintage accounts. The reversal of timing differences generally occurs when the amount of the tax depreciation taken with respect to an asset is less than the amount of the regulatory depreciation taken with respect to the asset. The excess deferred tax reserve is multiplied by a formula that is designed to insure that the excess is reduced to zero at the end of the regulatory life of the asset that generated the reserve.

Repeal of the 1986 Act provision, requiring normalization of excess deferred tax reserves, would permit public utility commissions to adopt their own rules governing the speed with which excess deferred tax reserves are reduced for purposes of establishing utility rates.

* * * * *

FOR IMMEDIATE RELEASE
WEDNESDAY, DECEMBER 2, 1987

PRESS RELEASE #6
SUBCOMMITTEE ON SELECT
REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1712

THE HONORABLE CHARLES B. RANGEL (D., N.Y.),
CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES,
COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES PUBLIC HEARINGS ON H.R. 1049, THE UTILITY RATEPAYER REFUND
ACT OF 1987 AND H.R. 2792, PROVIDING TAX EXEMPTION FOR INCOME ARISING
FROM THE EXERCISE OF INDIAN FISHING RIGHTS

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold public hearings on Monday, December 14, 1987, on H.R. 1049, a bill introduced by Mr. Dorgan (D., N.D.), a member of the Subcommittee and cosponsored by Jim Moody, Richard Gephardt, Andy Jacobs and William Coyne, members of the Committee, and others; and H.R. 2792, a bill introduced by Mr. Lowry (D., Wash.) and cosponsored by Congressmen Robert Matsui, Harold Ford, Marty Russo and Rod Chandler, members of the Committee, and others. The hearings will be held in room 2218 Rayburn House Office Building beginning at 10:00 a.m. The hearing on H.R. 1049 will be held first.

H.R. 1049

In press release #5, November 10, 1987, the Subcommittee on Select Revenue Measures announced its intention to hold a hearing on this bill without specifying a date. Background information regarding H.R. 1049 is contained in that press release.

H.R. 2792

Background -- H.R. 2792 is intended to clarify that Indian treaties, executive orders and Acts of Congress under which the rights of any Indian tribe to fish are secured, shall be construed to prohibit the imposition of any state or federal tax on the income derived by a tribal member from the exercise of such a secured right.

Action by the Committee on Interior and Insular Affairs -- H.R. 2792 has been reported favorably by the Committee on Interior and Insular Affairs, to which the bill was jointly referred. (H. Report 100-312, Part 1, September 21, 1987.)

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler [(202) 225-1712] no later than Monday, December 7, 1987, to be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Subcommittee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee [(202) 225-9710].

Persons and organizations having a common position are urged to make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. (See formatting requirements below.) This process will afford more time for members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

(MORE)

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 100 copies of their prepared statements to the Subcommittee office, room 1111 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business, Friday, December 18, 1987, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Subcommittee office, room 1111 Longworth House Office Building, before the hearing begins.

FORMATTING REQUIREMENTS:

COMMITTEE ON WAYS AND MEANS FORMATTING REQUIREMENTS FOR PRINTING OF HEARING STATEMENTS, WRITTEN COMMENTS AND EXHIBITS

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will ~~not~~ be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

FOR IMMEDIATE RELEASE
FRIDAY, DECEMBER 4, 1987

PRESS RELEASE #7
SUBCOMMITTEE ON SELECT REVENUE
MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE
BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A HEARING ON THE TAXATION OF HOUSING
BENEFITS FOR INDIVIDUALS EMPLOYED BY, OR ASSIGNED TO,
THE U.S. MISSION TO THE UNITED NATIONS

The Honorable Charles B. Rangel (D. N.Y.), Chairman,
Subcommittee on Select Revenue Measures, Committee on Ways and
Means, U.S. House of Representatives today announced a hearing on
the taxation of housing benefits for individuals employed by, or
assigned to, the U.S. Mission to the United Nations to be held on
Monday, December 14, 1987, in room 2218 Rayburn House Building.
This hearing will begin after the completion of the previously
announced hearings on H.R. 1049 and H.R. 2792. The hearing on
H.R. 1049 will begin at 10:00 a.m.

The Foreign Relations Authorization Act, Fiscal Years 1988
and 1989, now in conference, may reform the types and amounts of
housing allowances or other housing benefits that may be received
by individuals employed by, or assigned to, the U.S. Mission to
the United Nations. These benefits have historically been
provided to compensate rotating employees for the high cost of
temporary housing in New York City, and particularly in the
vicinity of United Nations headquarters.

The hearing will examine present and prior tax treatment of
these benefits and whether modification of present-law treatment
is appropriate.

In announcing the hearing, Chairman Rangel stated, "The
Committee on Ways and Means has assured the Members of the
Committee on Foreign Affairs that this issue will receive an
immediate but thorough review. Consequently, this question is
being added on short notice to those issues already being
addressed at the December 14 Subcommittee hearing."

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral
testimony before the Subcommittee must submit their requests to
be heard by telephone to Harriett Lawler [(202) 225-1721] no
later than close of business, Wednesday, December 9, 1987, to be
followed by a formal written request to Robert J. Leonard,
Chief Counsel, Committee on Ways and Means, U.S. House of
Representatives, 1102 Longworth House Office Building,
Washington, D.C. 20515. The Subcommittee staff will notify by
telephone those scheduled to appear as soon as possible after the
filing deadline. Any questions concerning a scheduled appearance
should be directed to the Subcommittee at [(202) 225-9710].

It is urged that persons and organizations having a common
position make every effort to designate one spokesperson to
represent them in order for the Subcommittee to hear as many
points of view as possible. Time for oral presentations will be
strictly limited with the understanding that a more detailed
statement may be included in the printed record of the hearing.
This process will afford more time for members to question
witnesses. In addition, witnesses may be grouped as panelists
with strict time limitations for each panelist.

(MORE)

-2-

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 100 copies of their prepared statements to the Subcommittee office, room 1111 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business, Friday, December 18, 1987, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Subcommittee office, room 1111 Longworth House Office Building, before the hearing begins.

FORMATTING REQUIREMENTS:

COMMITTEE ON WAYS AND MEANS FORMATTING REQUIREMENTS FOR PRINTING OF HEARING STATEMENTS, WRITTEN COMMENTS AND EXHIBITS

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

* NOTICE--CHANGE IN ROOM *

FOR IMMEDIATE RELEASE
FRIDAY, DECEMBER 11, 1987

PRESS RELEASE #6 AND 7-REVISED
SUBCOMMITTEE ON SELECT REVENUE
MEASURES
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-9710

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A CHANGE IN ROOM FOR THE DECEMBER 14, 1987,
SUBCOMMITTEE HEARINGS

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced a change in room for the hearings scheduled for Monday, December 14, 1987, on H.R. 1049, H.R. 2792, and on the issue of taxation of housing benefits for individuals employed by, or assigned to, the U.S. Mission to the United Nations. The December 14, 1987, hearings will now be held in 2322 Rayburn House Office Building, beginning at 10:00 a.m.

All other details concerning the December 14, 1987, hearings remain the same (see Press Releases #6 and #7, dated December 2, and December 4, 1987, respectively).

100TH CONGRESS
1ST SESSION

H. R. 1049

To repeal the provision of the Tax Reform Act of 1986 which limits the benefits to consumers from the effect of the corporate rate reduction on deferred tax reserves of public utilities.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 9, 1987

Mr. DOBGAN of North Dakota introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To repeal the provision of the Tax Reform Act of 1986 which limits the benefits to consumers from the effect of the corporate rate reduction on deferred tax reserves of public utilities.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the "Utility Ratepayer Refund
5 Act of 1987".

1 SEC. 2. REPEAL OF EXTENSION OF NORMALIZATION RE-
2 QUIREMENT TO TREATMENT OF EXCESS DE-
3 FERRED TAX RESERVES.

4 (a) IN GENERAL.—Subsection (e) of section 203 of the
5 Tax Reform Act of 1986 (relating to normalization require-
6 ments) is hereby repealed.

7 (b) EFFECTIVE DATE.—The repeal made by subsection
8 (a) shall take effect as if subsection (e) of section 203 of such
9 Act had never been enacted.

○

100TH CONGRESS
1ST SESSION

H. R. 2792

To clarify Indian treaties, Executive orders, and Acts of Congress with respect to Indian fishing rights.

IN THE HOUSE OF REPRESENTATIVES

JUNE 25, 1987

Mr. LOWRY of Washington (for himself, Mr. CHANDLER, Mr. DEFazio, Mr. MILLER of California, Mr. MILLER of Washington, Mr. MORRISON of Washington, and Mr. SIKORSKI) introduced the following bill; which was referred jointly to the Committees on Ways and Means and Interior and Insular Affairs

A BILL

To clarify Indian treaties, Executive orders, and Acts of Congress with respect to Indian fishing rights.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 SECTION 1. Section 2079 of the Revised Statutes (25
4 U.S.C. 71) is amended by striking out the period at the end
5 thereof and inserting in lieu thereof the following proviso:
6 “: *Provided*, That such treaties, and any Executive orders
7 and Acts of Congress under which the rights of any Indian
8 tribe to fish are secured, shall be construed to prohibit the
9 imposition, under Federal law or under any law of a State or

1 political subdivision thereof, of any tax on any income derived
2 by an Indian from the exercise of rights to fish secured by
3 such treaty, Executive order, or Act of Congress.".

4 SEC. 2. The provisions of this Act shall apply to any
5 period for which the statute of limitations or any other bar to
6 assessing tax has not expired.

○

Chairman RANGEL. The Select Revenue Subcommittee hearings will come to order.

Today, the Subcommittee on Select Revenues will hold hearings on two bills, H.R. 1049, the Utility Ratepayer Refund Act of 1987, and H.R. 2792, providing tax-exemption for income arising from the exercise of Indian fishing rights.

In addition, the subcommittee will receive testimony related to the tax treatment of housing benefits for individuals employed by or assigned to the U.S. Mission to the United Nations.

We will begin with H.R. 1049, and I expect that we will not get to H.R. 2792 until about 2 o'clock.

H.R. 1049, introduced by Mr. Dorgan, will repeal the provisions of the Tax Reform Act of 1986, which requires the normalization of excess-deferred tax reserves for regulated utility companies, resulting from the reduction of corporate income tax rates from 46 to 34 percent.

The repeal of this provision will permit public utility commissions to adopt their own rules governing the speed with which excess-deferred tax reserves are reduced for purposes of establishing utility rates.

H.R. 2792 is intended to clarify the Indian treaties, Executive orders, and acts of Congress under which the rights of any Indian tribe to fish are secured, should be construed to prohibit the imposition of any State or Federal tax on the income derived by a tribal member from the exercise of such a secured right.

The third portion of today's hearing, as I indicated before, will examine present and prior tax treatment of housing benefits for individuals employed by or assigned to the U.S. Mission to the United Nations.

The Foreign Relations Authorization Act of fiscal year 1988 and 1989, now in conference, may reform the types and amounts of housing allowance, and other housing benefits that will be received by United Nation employees.

These benefits have historically been provided to compensate rotating employees for the high cost of temporary housing in New York City, and particularly in the vicinity of the United Nations headquarters.

Treasury Department views on all three issues before us will be presented by Eugene Steuerle, Deputy Assistant Secretary of Treasury.

The ranking member of this subcommittee, Mr. Vander Jagt, has an opening statement.

Mr. VANDER JAGT. Thank you very much, Mr. Chairman. As usual, you have outlined the issues before us very accurately and very well. I think the day demonstrates the diversity of issues before this subcommittee, all the way from tax reserves of utilities to the treatment of income of Indians and fishing territorial waters, to housing and the delegation to the United Nations. So we will be moving from New York City to Indian territorial waters to the telephone on the desk, and the kitchen wall of every person in America. And I would like to thank all of our witnesses who have come from across America to share their knowledge and their insight on these complex issues.

Thank you very much for being here, and thank you, Mr. Chairman.

Chairman RANGEL. Thank you. I was really surprised to see the interest that people had in Indian fishing rights this morning. [Laughter.]

Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman. Mr. Chairman, let me make a brief opening statement. I will keep it brief because the length of the agenda here will keep us here for some long while.

We will talk today about \$19 billion worth of excess-deferred taxes, that utilities owe to customers, and when customers should receive these refunds.

Let me emphasize that the hearing today is not about normalization.

I read some of the testimony that will be offered today, and some suggest that this hearing is about normalization. Some today will assert that we are attempting to roll back normalization. This hearing is not about normalization. This does not affect the normalization issue.

Normalization is a subject that we have discussed previously in Congress. It allows the utility companies to collect from customers the tax at the statutory rate, which they will eventually pay the Federal Government, and which they may normalize.

So, normalization is a timing issue. There is no timing issue with respect to excess-deferred taxes, that is, \$19 billion that has been collected must now go back to the customers. The question is when.

The reason I introduced this legislation, Mr. Chairman, is I believe it is unprecedented for the Federal Government to tell the State regulatory bodies that they are not able to analyze, on a case by case basis, when any given utility company ought to be returning excess-deferred taxes to its customers.

I note that some utility companies are cash flush; others are not. Those that are cash flush are using that cash to buy drug stores, savings banks, insurance companies, and a host of other businesses.

Utilities form holding companies, and diversify into other areas I assume—and I guess we will ask some questions about that today—that at least a part of the cash that they use for that diversification, is from the \$19 billion that utilities owe to the customers.

So this is an important issue, and one that I am pleased the chairman has agreed to hold hearings on today. I hope at the conclusion of these hearings we will have some more information on both sides of the issue with which to make a reasoned judgment about what Congress ought to do with respect to section 203(e) of the 1986 Tax Reform Act.

Mr. Chairman, thank you very much.

[Mr. Dorgan submitted the following:]

Statement by the Honorable Byron L. Dorgan
on H.R. 1049, the Utility Ratepayer Refund Act of 1987
before the Subcommittee on Select Revenue Measures
December 14, 1987

When we in Congress passed the Tax Reform Act of 1986, we thought we brought more fairness to the tax code. We eliminated loopholes, we discouraged tax-motivated investments, and we reduced the tax rates for all Americans.

Unfortunately, there was a "wrinkle" in the Tax Reform Act -- an obscure section which is preventing utility customers from receiving a timely refund of \$19 billion in excess deferred taxes. Under Section 203(e) utilities may "normalize" the return of this \$19 billion, which means consumers will wait as long as 30 years for the full refund.

H.R. 1049, the Utility Ratepayer Refund Act of 1987 simply repeals Section 203(e) of the 1986 TRA. The result would be that federal and state regulatory authorities would be able to decide on a case-by-case basis when ratepayers should be refunded this \$19 billion. Thus, H.R. 1049 is in keeping with the major goal of tax reform -- fairness.

You might be wondering from where this \$19 billion came. For years the tax laws have allowed utilities (gas, electric, telephone, water) to depreciate plant and equipment over different lengths of time for income tax and ratemaking purposes. Utilities today may collect through today's rates federal income taxes that will not be owed to the Treasury for many --perhaps 20 to 30 -- years. These are called "deferred taxes", and collectively the utilities hold about \$73 billion in accumulated deferred taxes.

Consumers have been paying utility bills based on the anticipation that utilities eventually will pay Federal taxes at 46% on corporate earnings (48% prior to 1979). But, the 1986 TRA reduced the corporate tax rate from 46% to 34%. Thus, utilities no longer owe the Federal government all the deferred taxes previously collected from consumers. About \$19 billion is owed to the ratepayers, and these represent "excess deferred taxes". The utilities acknowledge that this money must be returned to ratepayers, but utilities want to hold onto it for as long as possible.

How much are the utilities holding in excess deferred taxes? Here are some examples:

Commonwealth Edison ----over \$530 million
Pacific Gas and Electric ---- over \$29 million
Columbia Gas Transmission --- over \$121 million
AT&T--over \$768 million
Mountain States Telephone Co.----over over \$391 million

I believe that Section 203(e) is unfair to utility customers -- both residential and industrial users. Under Section 203(e) senior citizens can expect to get the final installment of their refund in the year 2017! For consumers who are struggling to keep their job, or to keep food on the table, or to pay their utility bills, the promise of a refund over thirty years is no consolation. That's why so many consumer groups are supporting my legislation. Not one consumer group endorses Section 203(e).

Today you will hear some arguments against my bill by utilities, saying that they cannot possibly refund this \$19 billion any sooner than by normalizing. I remain unconvinced. While a few utilities are strapped for cash, many are "cash flush" because of swollen cash flows. Sluggish utility demand has caused affluent utilities to diversify. Many no longer need to build plants so they have cash to spare. The fruits of high cash earnings and low construction financing are evident:

-- AZP, the holding company for Arizona Public Service Co. purchased the state's largest savings bank not long ago

-- Florida Progress Corp, the holding company for Florida Power Co has explored the possibility of acquiring a baseball team

--Pacific Lighting Corp bought Thrifty Drugstore chain last year for \$875 million

Diversification requires cash, and these examples show utilities have plenty of cash despite their protests to the contrary. Given this fact, many utilities are in a good position to repay excess deferred taxes in a more timely fashion.

Does HR 1049 mandate a faster return of these excess deferred taxes? Absolutely not! This bill simply lets the Federal and State regulators decide on a case-by-case basis what an appropriate refund schedule should be. This is only fair. Afterall, does it make sense for the federal government to decide across the board that all utilities can return these excess taxes in thirty years? Should the federal government get involved in what is a regulatory decision? Should a healthy utility be treated the same as a financially strapped one? The regulators are the ones best equipped to make these decisions.

Some witnesses before us today will argue that my bill is an attack on normalization and longstanding federal tax policy. These characterizations are false. Excess deferred taxes will never be paid to the Treasury. Moreover, there has been no longstanding policy on normalization as it affects excess deferred taxes. I think this an appropriate time to share with you what happened in 1979 when the corporate rate dropped and utilities had an excess deferred tax reserve that had to be returned to ratepayers. At that time the regulatory authorities were able to make a decision on the refunds of these excess taxes. The 1978 tax act was silent on the treatment of excess deferred taxes. At that time very few states ordered immediate refunds. Some ordered them in a 3-5 year period. Some allowed 10 years, and others allowed normalization of the refunds. So no one can argue today that all state utility commissions are going to force the utilities to return the funds immediately. That's ludicrous.

There is one more curious thing you should know about this 1979 rate reduction. The IRS, in a private letter ruling, found that the excess deferred taxes created by this rate drop did not have to be normalized. It determined that it was up to the regulators. The IRS concluded that as long as the balance in the deferred account was large enough to fund projected tax liabilities under the new tax rate, the normalization requirements were met. The excess balances could be returned to the ratepayers as the commissions chose. So much for the argument that there is a longstanding federal tax policy on this issue that we need to protect!

The intent of HR 1049 again is that regulatory authorities should decide when the \$19 billion goes to ratepayers. This is the only fair approach to these excess deferred taxes. Let's get the federal government out of an area of regulation in which it does not belong. This is a reasonable bill that unties the hands of the regulators and gives the consumer a fair shake!

I am pleased a broad coalition supports this bill: consumer groups, industrial users, regulatory authorities, and more. I'd like to enter some of these letters and comments of endorsement into the record.

I look forward to a full and open airing of the issues surrounding this bill today. Thank you, Mr. Chairman.



STATE OF ILLINOIS

Illinois Commerce Commission

MARY B. BUSHNELL
Chairman

STATE OF ILLINOIS CENTER
100 West Randolph Street
Suite 9 - 100
Chicago, Illinois 60601

Statement of the Illinois Commerce Commission

The Illinois Commerce Commission supports HR 1049, introduced by Representative Byron Dorgan, which would repeal Section 203(e) of the Tax Reform Act of 1986.

The lower corporate rate provided for by the new tax law reduces the federal tax obligation of the nation's public utilities. As a result, they are no longer obligated to pay all of the deferred federal taxes previously collected from ratepayers under "normalization," an accounting treatment that allows tax benefits to be spread over the life of investments.

According to the National Association of Regulatory Utility Commissioners (NARUC), excess deferred taxes for the electric, gas pipeline, and telephone utilities exceed \$19 billion nationally. A substantial share of this amount is attributable to Illinois public utilities. (See the attached table.) Even the utility companies recognize that these funds are owed to their customers and most companies have the cash to repay them.

Section 203(e) of the Tax Reform Act requires the refund of excess deferred taxes to be normalized, or spread over time, which means that the repayment to ratepayers could take as long as thirty years. This provision preempts state utility regulators from determining the appropriate ratemaking treatment of excess deferred taxes and an appropriate refund schedule based on each regulated utility's financial condition.

The tax code should not determine or specify any ratemaking treatment or refund schedule for excess deferred taxes. These decisions rightfully belong to state public utility regulators, who can use informed judgment to protect the interests of both the customers and shareholders of our public utilities. We join the NARUC and a host of other organizations in these assertions.

The Illinois Commerce Commission urges Congress to repeal Section 203(e) of the Tax Reform Act of 1986 and remedy a taxation policy that is detrimental to Illinois utility ratepayers and preemptive of our state regulatory jurisdiction.

Mary B. Bushnell
Mary B. Bushnell
Chairman

**Accumulated Deferred Federal Income Taxes for
Selected Illinois Public Utilities, 1986***

	Excess Deferred Federal Taxes From Accelerated <u>Depreciation</u>
<u>Electric and Gas</u>	
Commonwealth Edison	\$ 367,956,472
Northern Illinois Gas	49,788,513
Illinois Power	46,109,384
Central Il. Public Service	43,976,232
Peoples Gas Light & Coke	29,694,625
Central Illinois Light	27,803,724
North Shore Gas	3,365,926

Telephone

Illinois Bell Telephone	\$ 171,785,110
General Telephone	22,493,182
Central Telephone	9,890,528
Continental Telephone	6,848,305
Illinois Consolidated	2,355,154
Alltel Illinois	1,284,225

* These amounts are considered to be conservative estimates.
Source: Illinois Commerce Commission Annual Reports for 1986
(pages 71-74 for Electric and Gas and page 35A for Telephone
Utilities). These estimates only consider excess deferred taxes
attributable to accelerated depreciation and are based on a
multiplication of accounts by 12/46 to reflect the reduction in
the federal tax rate.

National Association of Regulatory Utility Commissioners

Incorporated

PETER A. BRADFORD, *President*
Maine Public Utilities Commission
212 State Street, State House Station 18
Augusta, Maine 04333

1102 Interstate Commerce Commission Building
Constitution Avenue and Twelfth Street, N.W.
Post Office Box 684, Washington, D.C. 20044-0684

BRUCE HAGEN, *First Vice President*
North Dakota Public Service Commission
State Capitol
Bismarck, North Dakota 58505

HENRY G. YONCE, *Second Vice President*
South Carolina Public Service Commission
111 Doctors Circle, Post Office Box 11649
Columbia, South Carolina 29211



Telephone: 202-898-2200

PAUL RODGERS
Administrative Director
General Counsel

GAIL ARGIRO
Treasurer

April 17, 1987

Dear Representative:

We wish to bring to your attention the Utility Ratepayer Refund Act of 1987 (H.R. 1049), a bill introduced by Rep. Byron Dorgan (D-ND) with the bipartisan support of 26 cosponsors. This proposed legislation would correct an injustice in the Tax Reform Act of 1986 which delays billions of dollars in potential refunds to utility ratepayers. It would not affect the payment of taxes, however, so it does not threaten the fabric of Tax Reform.

For years, our nation's utilities have been allowed to depreciate equipment over different lengths of time for ratemaking and income tax purposes. The result is a deferred tax obligation which allows utilities to collect through today's rates taxes that will not be due the Federal government for many years. The \$15 billion at issue in the Dorgan bill are "excess deferred taxes" collected from ratepayers to pay future utility tax liabilities which no longer exist because the corporate tax rate has been lowered from 46 to 34 percent.

AT&T Communications, for example, has \$643 million it collected from telephone ratepayers for Federal income taxes it no longer owes the government. Similarly, Commonwealth Edison holds over \$488 million. (See attached for statistics on utilities serving your district.)

A provision of the new Tax Reform Act, Section 203(e), allows utilities to take up to 30 years to return these excess deferred taxes to their customers and effectively bars State utility regulators from ordering faster refunds.

We believe that State utility commissions should decide how and when to refund utilities' excess deferred taxes on a case-by-case basis taking into account both the financial health of each utility and the needs of their customers.

Under current law, millions of senior citizens and businesses in financial hardship will never receive their rightful share of these refunds. Yet many utility companies currently have cash surpluses and are free to invest their excess deferred taxes in non-utility business ventures such as insurance companies and real estate development.

H.R. 1049 would not mandate a refund schedule for excess deferred taxes; it would simply remove the Federal restriction—Section 203(e)—which prevents regulators in your State from ordering refunds appropriate to the unique circumstances of its utilities and its customers. The States had this discretion after the 1978 cut in the maximum corporate tax rate from 48 to 46 percent. Then the utilities had the burden of proving why their excess funds should not be returned promptly to their ratepayers.

-2-

Now, in 1987, billions more ratepayer dollars are at stake. This is why the National Association of Regulatory Utility Commissioners (NARUC), which represents all state utility regulators, adopted a unanimous resolution (enclosed) endorsing the repeal of Section 203(e) of the tax code.

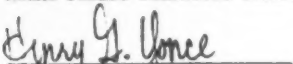
The NARUC and hundreds of industrial and residential consumer groups across the nation strongly urge you to cosponsor H.R. 1049.

Thank you for your attention to this important matter. If you would like further information, please contact Caroline Chambers at (202) 898-2205.

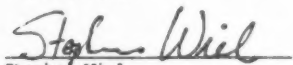
Sincerely,



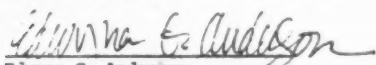
Peter A. Bradford
NARUC President
Chairman
Maine Public Utilities Commission



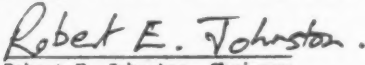
Henry G. Yonce
NARUC Second Vice President
South Carolina Public Service
Commission



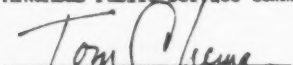
Stephen Wiel
Chair, Committee on Energy
Conservation
Nevada Public Service Commission



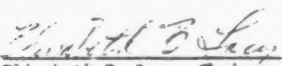
Edwyna G. Anderson
Chair, Committee on Electricity
Michigan Public Service Commission



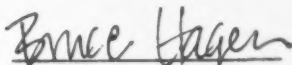
Robert E. Johnston, Chairman
Arkansas Public Service Commission



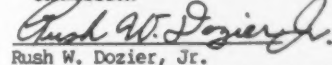
Thomas Chema, Chairman
Ohio Public Utilities Commission



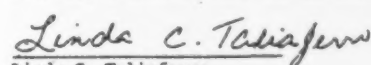
Elizabeth B. Lacy, Chairman
Virginia State Corporation Commission



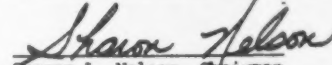
Bruce Hagen
NARUC First Vice President
Chair, Committee on Communications
North Dakota Public Service
Commission



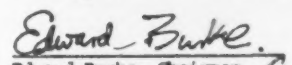
Rush W. Dozier, Jr.
Chair, Committee on Finance and
Technology
Kentucky Public Service Commission



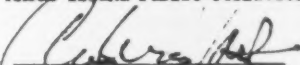
Linda C. Taliaferro
Chair, Committee on Administration
Chairman
Pennsylvania Public Utility Commission



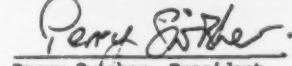
Sharon L. Nelson, Chairman
Washington Utilities and
Transportation Commission



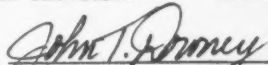
Edward Burke, Chairman
Rhode Island Public Utilities Commission



Andrew Varley, Chairman
Iowa State Utilities Board



Perry Swisher, President
Idaho Public Utilities Commission



John T. Downey, Chairperson
Connecticut Public Utilities Control Authority



NEW MEXICO PUBLIC SERVICE COMMISSION

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GARREY CARRUTHERS
CHAIRMAN

MARIAN HALL, 224 EAST INDEPENDENCE AVENUE, SANTA FE, NEW MEXICO

JOSEPH E. SAMORA, JR.
CHAIRMAN
MARTIN J. BLAKE
COMMISSIONER
S. PETER BICKLEY
COMMISSIONER

November 24, 1987

Mr. Fred O'Cheskey, Manager
Corporate Public Affairs
Public Service Company of New Mexico
Alvarado Square
Albuquerque, New Mexico 87158

Dear Fred:

As you are aware, your letter to Governor Garrey Carruthers regarding utilities deferred taxes has been forwarded to us for review and analysis, and we are hereby submitting this letter as a response.

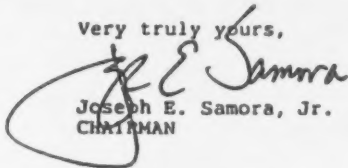
The Public Utility Act, section 62-3-1, NMSA 1976 annotated, mandates that the Commission must take into account the public interest, interest of consumers and the interest of investors in arriving at fair, just and reasonable rates. We fail to see how any legislation which ostensibly ties the hands of regulators could be anything but a hinderance in the performance of our duties. Subsection (e) of section 203 of the Tax Reform Act of 1986 does exactly that. This subsection requires that the return of excess tax reserves to ratepayers must follow a specific formula, the average rate assumption method (ARAM), or the utility will lose the benefits of using the accelerated cost recovery system (ACRS).

Our duty in balancing the various interests, public, consumers and industries, is a complex and difficult task and does not lend itself well to the simple application of a formula. A Commission must review the facts and circumstances of each case and have the discretion to determine the course of action which will best accomplish this delicate balancing. H.R. 1049 would repeal section 203 (e) which requires use of ARAM. This merely returns to State Commissions the discretion necessary to arrive at a method which is best suited for utilities under its jurisdiction for the return of the 'excess' deferred taxes. This certainly does not mean that the Commission is against ARAM or

vedded to another approach. The Commission is simply in favor of having the opportunity to exercise its discretion after full evidentiary proceedings. Rest assured that the Commission is not insensitive to the effect that any methodology may have on utilities or overly sensitive to the desire of consumers for the immediate return of these overcollections. Our balancing act would dictate that these are certainly two of the many factors to be considered in arriving at an equitable solution. Finally, any decision on this matter will not be made on the basis of being 'politically appealing' but on the merits of the case.

Therefore, we support H.R. 1049 as it is presently proposed and feel that its passage would be in the best interest of all the interests we serve.

Very truly yours,



Joseph E. Samora, Jr.
CHAIRMAN

JES,jr/cv

cc: The Honorable Governor Garrey Carruthers
Mr. Al Mallett

Chairman RANGEL. Thank you. Mr. McGrath.

Mr. McGRATH. Thank you, Mr. Chairman, and I, too, want to welcome our witnesses here today to testify on the Utility Ratepayer Refund Act.

I am hopeful that the witnesses will be able to discuss the impact this legislation may have on the utilities, and on the ratepayers that they represent.

I have several concerns relating to this bill. First, I think the enactment of this legislation would break a promise that we made when we enacted the historic Tax Reform Act of 1986. During that particular act, we took a pretty good bite out of some of the utilities in this country by eliminating the investment tax credit, by stretching out depreciation schedules, and by changing classifications of equipment in those depreciation schedules. I think we may do some harm, perhaps, with this particular bill, and would probably go back on the word that we had given during those proceedings.

Furthermore, I think that the provisions of H.R. 1049 were discussed during the drafting of the tax reform bill, and the committee decided, at that particular time, for some very good reasons, not to include them. I think the reasons are even more compelling now.

In my own State of New York, many of the utilities have signed long-term contracts with the Public Service Commission, and have agreed not to increase rates for over 5 years. These contracts were signed with the assumption that these moneys would be available to hold rates down.

A second concern I have with the bill is that I am not sure it would accomplish what it sets out to do, which is to reduce rates for utility customers.

I think that it may have that effect in the short run, but perhaps in the long run, it may not. If, after the utilities have to refund the \$15 billion required by this bill, they would have to go out to the market in order to borrow, in order to satisfy their capital needs.

If all the utilities had to do this, with the influx of the amount of borrowing of this magnitude, I think ratepayers may have to face higher rates due to higher interest charges, and I do not think that is what we had in mind.

Finally, I think this bill has some problems in another area. This bill does not provide one nickel to the Federal Treasury, and I think that was perhaps one of the reasons why it was dismissed during the tax reform consideration.

I question the advisability of this particular provision, at this time, because of the enactment of the Tax Reform Act. However, my ears are open. They are ears of a skeptic at this point in time. I am anxious to hear the testimony of our witnesses, and I thank the chairman for bringing this subject to our attention.

Chairman RANGEL. I am glad to see you have an open mind on this issue. [Laughter.]

Mr. McGRATH. Stronger language to follow.

[By subsequent unanimous consent, Mr. Flippo inserted the following:]

OPENING STATEMENT OF CONGRESSMAN RONNIE G. FLIPPO ON PROPOSED REPEAL OF
NORMALIZATION PROVISIONS OF THE 1986 TAX ACT

I commend Chairman Rangel (D-NY) for holding this hearing on an important and complex tax accounting provision set out in the recently approved 1986 Tax Act. This provision dealing with normalization of deferred income taxes is of great interest to all my constituents either as users of public utility services or as suppliers of these services.

Most will agree that the Tax Reform Act of 1986 is probably the most comprehensive revision of the Federal tax laws in the history of our country. Three long years of intense debate, analysis and compromise preceded the passage of this landmark legislation. The combined effects of its many complex provisions on all types of taxpayers, on the economy and on the U.S. Treasury were carefully balanced to develop fair and equitable changes to our tax laws. Because of this careful balance that was struck in developing the Tax Act, I believe it would be inappropriate to make a single change in one area of that Act that would upset its intended economic effects.

All of us are here this morning to consider a single provision of the Act—Section 203(e) which allows public utilities to continue the use of normalization accounting for deferred federal income taxes. That section, like every other section in the Act, was carefully considered prior to its inclusion in the final version of the Act. That Section is beneficial to all Americans because it provides public utilities with a needed source of capital. This capital is invested in productive plant and equipment so as to provide the utility services that all of us have come to take for granted. Without this capital, we would be faced with either a lower quality of utility service or higher utility rates.

I firmly believe that if we change this normalization provision or any other single provision of the Act, we will seriously upset the balance that we and our fellow congressmen worked so diligently to achieve, less than 14 months ago, in the final version of the 1986 Tax Act. We are not here dealing with a minor or technical amendment; we are here dealing with a substantive provision of the 1986 Tax Act. The repeal of Section 203(e) of the Act will serve as an invitation to reexamine other provisions of the Act in isolation. The only possible result will be a haphazard undoing of the basic underpinnings of the Act with untold effects on taxpayers, the economy and the Treasury revenues. Let's let the Act, the culmination of all of our efforts, remain intact and give it time to produce its intended results.

Chairman RANGEL. The Chair welcomes the attendance of Mr. Brown of Colorado and Mr. Coyne of Pennsylvania, and we will call our first witness, Mr. Steuerle of the Treasury Department, and if it is not too much of a burden, we would ask you to comment on the three issues before the committee.

But we will pause after the first bill, so that members may inquire. Is that all right with you, Mr. Steuerle?

STATEMENT OF HON. C. EUGENE STEUERLE, DEPUTY ASSISTANT
SECRETARY (TAX ANALYSIS), DEPARTMENT OF THE TREASURY

Mr. STEUERLE. That is fine, Mr. Chairman.

Chairman RANGEL. Thank you.

Mr. STEUERLE. And with your permission, also, I will just give a short summary of my testimony, and submit the full testimony for the record.

Chairman RANGEL. Without objection.

Mr. STEUERLE. Mr. Chairman, members of the committee, I am pleased to have this opportunity to present the views of the Treasury Department with respect to the following matters: H.R. 1049, which would repeal certain normalization requirements for public utility property; H.R. 2792, which would provide a tax exemption for income derived from Indian fishing rights; and certain issues regarding the Federal income tax treatment of housing allowances for individuals employed by or assigned to the U.S. Mission to the United Nations. I will discuss each of these proposals in turn.

H.R. 1049, The Utility Ratepayer Refund Act of 1987, would repeal section 203(e) of the Tax Reform Act of 1986. This section requires excess-deferred tax reserves attributable to accelerated tax depreciation of public utility property to be normalized over the remaining useful life of the property. These excess-deferred taxes have resulted from a reduction in Federal income tax rates brought about by the 1986 act.

The Treasury Department opposes H.R. 1049. Public utility normalization represents a longstanding policy, supported over the years by several Congresses and administrations, which should not be changed on a selective basis. Normalization of excess-deferred tax reserves ensures that the full beneficial effect of the reduction in tax rates achieved under the 1986 act is generally available in a consistent and uniform fashion, over time, to consumers of products and services of regulated utilities. By repealing the normalization requirements of section 203(e), H.R. 1049 would unnecessarily favor the current generation of consumers over future generations of consumers. Moreover, the repeal of the normalization requirements would cause unnecessary and economically undesirable fluctuations in utility prices charged to ratepayers. Current ratepayers would be undercharged for their cost of service while future ratepayers would similarly be overcharged, resulting in distortions in the consumption of utility services over time, and obvious problems of equity.

In addition, we believe that H.R. 1049 would place additional and unnecessary burdens on the Nation's capital markets resulting from the requirement that utilities replace the capital financing lost through the flowthrough of deferred taxes. Under H.R. 1049, we believe that utilities would be forced to access the capital markets to obtain significant amounts of new equity and debt capital. This development would strain an already sensitive market at an especially inappropriate time.

And finally, the normalization requirements for excess-deferred taxes were one of the many important compromises that led to the enactment of the 1986 Tax Reform Act. We believe that it is inappropriate to reconsider these basic agreements at this time.

Since 1969, Congress has imposed certain limitations on the ability of regulated public utilities to use accelerated methods of depreciation. These limitations, referred to as the "normalization rules," generally require that certain regulatory accounting practices be used in setting a utility's rates. In the Tax Reform Act, Congress extended the normalization requirements of prior law to the new, modified, accelerated cost recovery system. In addition, the 1986 act provided a new normalization rule concerning the transitional effects on utility regulatory accounting of the reduction in corporate rates.

In setting the rates that utilities charge to customers, utility regulators have two basic goals: first, to establish rates that adequately cover the cost of providing utility service, and second, to minimize the cost of providing those services. The rates that utilities charge for services must be sufficient to cover current expenses such as labor, fuel, and taxes, and the cost of acquiring and using capital assets to provide these services. Rates are set so that con-

sumers are charged a price that reflects a fair, but not excessive, rate of return to capital.

When taxpayers are allowed to use accelerated methods of depreciation, tax depreciation is more rapid than the actual economic or physical deterioration of capital, and the economic effect is the deferral of tax liability. The result is the same as if the Treasury were to extend a series of interest-free loans to the taxpayers during the early years of an asset's life, these loans being repayable in the later years. This extension of interest-free financing is effectively available to any taxpayer, whether in the regulated or the nonregulated sector of the economy.

Under regulatory accounting practices required by the normalization rules, the deferrals of tax are explicitly recognized as interest-free loans. Reserves for deferred taxes are thus viewed as part of the utility's capital structures. The utility's cost of service is reduced by virtue of these benefits obtained through this zero-cost financing represented by the deferred tax reserves. Normalization is the proper accounting treatment for these interest-free loans because normalization recognizes the economic nature of these tax deferrals.

If the income tax expenses for which ratepayers are charged are reduced immediately by the capital subsidy inherent in accelerated depreciation—the procedure commonly called flowthrough—then current ratepayers would be undercharged for the cost of service, while future ratepayers would be required to make up the difference. In contrast, with normalization both current and future ratepayers benefit from the reduction in the cost of service achieved by interest-free financing.

Recall that this financing is used by the utility in lieu of equity and interest-bearing debt that demand a rate of return, that rate of return implying increased cost of service.

The normalization rules of section 203(e) differ slightly from previous normalization rules existing before the 1986 act, in that section 203(e) deals with excess tax reserves resulting from the application of tax-rate reductions to accumulated deferrals. Nevertheless, both types of normalization rules are integrally concerned with the effects of tax deferral from the use of accelerated depreciation on regulatory accounting. Normalization of excess-deferred tax reserves encourages the equitable allocation of a Federal income tax benefit to the utility ratepayers over the remaining life of the property. If the tax benefits would flow through to ratepayers on an uneven and accelerated basis, utility rates for current ratepayers would be too low, leading to overconsumption of utility services, and temporary but unsustainable growth in industry output.

We also have some concerns regarding the effect of the enactment of H.R. 1049 on the Nation's capital markets. Utilities would be forced to resort to the capital markets to replace the loss of deferred taxes with additional debt and equity capital.

In addition, enactment of this bill would effectively reduce the Nation's aggregate savings because an immediate flowthrough of savings in the form of deferred taxes would be spent in part on consumption rather than saved in its entirety.

Finally, we believe that it is inappropriate to consider a change in the law regarding normalization of deferred tax reserves, which is an important provision in the overall package regarding capital-cost recovery contained in the 1986 act.

Mr. Chairman, I take it you would like me to pause now before I proceed with the other parts of my testimony.

[The prepared statement follows:]

For Release Upon Delivery
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 December 14, 1987

STATEMENT OF
 C. EUGENE STEUERLE
 DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)
 DEPARTMENT OF THE TREASURY
 BEFORE THE
 SUBCOMMITTEE ON SELECT REVENUE MEASURES
 OF THE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and members of the Subcommittee:

I am pleased to have this opportunity to present the views of the Treasury Department with respect to the following matters: H.R. 1049, which would repeal certain "normalization" requirements for public utility property; H.R. 2792, which would provide a tax exemption for income derived from Indian fishing rights; and certain issues regarding the Federal income tax treatment of housing allowances for individuals employed by or assigned to the U.S. Mission to the United Nations. I will discuss each of these proposals in turn.

H.R. 1049 -- UTILITY RATEPAYER REFUND ACT OF 1987

H.R. 1049, "The Utility Ratepayer Refund Act of 1987," would repeal section 203(e) of the Tax Reform Act of 1986 (the "1986 Act"). This section requires excess deferred tax reserves attributable to accelerated tax depreciation of public utility property to be normalized over the remaining useful life of the property. These excess deferred taxes have resulted from the reduction in Federal income tax rates brought about by the 1986 Act.

The Treasury Department opposes H.R. 1049. Public utility normalization represents a long-standing policy, supported over the years by several Congresses and Administrations, which should not be changed on a selective basis. Normalization of excess deferred tax reserves ensures that the full beneficial effect of the reduction in tax rates achieved under the 1986 Act is generally available, in a consistent and uniform pattern, over time to consumers of products and services of regulated utilities. By repealing the normalization requirements of section 203(e) of the Act, H.R. 1049 would unnecessarily favor the current generation of consumers over future generations of consumers. Moreover, the repeal of the normalization requirements would cause unnecessary and economically undesirable fluctuations in utility prices charged to ratepayers; current ratepayers would be undercharged for their cost of service while future ratepayers would similarly be overcharged, resulting in distortions in the consumption of utility services over time and obvious problems of equity.

In addition, we believe that H.R. 1049 would place additional and unnecessary burdens on the nation's capital markets resulting from the requirement that utilities replace the capital financing lost through the flow-through of deferred taxes. Under H.R. 1049, we believe that utilities would be forced to access the capital markets to obtain significant amounts of new equity and debt capital; this development would strain an already sensitive market at an especially inappropriate time.

Finally, the normalization requirements for excess deferred taxes were one of the many important compromises that led to the enactment of the 1986 Act. We believe that it is inappropriate

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to reconsider these basic agreements underlying the 1986 Act at this time.

Background and Description of Present Law

Since 1969, Congress has imposed certain limitations on the ability of regulated public utilities to use accelerated methods of depreciation with respect to property used in the trade or business of providing various utility services ("public utility property") such as electricity, water, gas and phone services. These limitations, referred to as the "normalization rules,"^{1/} generally require that certain regulatory accounting practices be used in setting a utility's rates in order for the utility to be eligible to use accelerated depreciation with respect to public utility property. Any utility failing to comply with the normalization rules is ineligible to use accelerated depreciation and must instead use, for Federal income tax purposes, a method of depreciation that is the same as the method of depreciation used for regulatory accounting purposes (typically, straight-line depreciation over a non-accelerated depreciable life).

In the Tax Reform Act of 1986, Congress extended the normalization requirements of prior law to the new modified accelerated cost recovery system ("ACRS") provided in section 168 of the Internal Revenue Code of 1986. Under modified ACRS, a regulated utility is allowed to use accelerated depreciation for Federal income tax purposes only if the utility (i) uses the same depreciation method in computing both its regulatory accounting ("book") tax expense and its book depreciation allowance recoverable in the cost of service, and (ii) maintains and adjusts a reserve for deferred taxes to reflect the difference between the method of depreciation used for book purposes and the method used for Federal income tax purposes. These normalization requirements are basically identical to those of prior law under section 168 of the Internal Revenue Code of 1954.

In addition, section 203(e) of the 1986 Act provided a new normalization rule concerning the transitional effects on utility regulatory accounting of the reduction in corporate tax rates provided under the 1986 Act. This normalization rule limits the rate at which the excess balance in a utility's reserve for deferred taxes, created by the reduction in tax rates under the 1986 Act, may be reduced and flowed-through to ratepayers. Any flow-through or reduction of the excess deferred tax reserve that is more rapid than allowed under this normalization rule results in the taxpayer's public utility property being ineligible for accelerated depreciation.^{2/}

^{1/} Normalization rules regarding the investment tax credit have also been present in the Internal Revenue Code since 1971. This testimony focuses principally on the normalization rules regarding depreciation.

^{2/} Under the Act, a utility's excess deferred taxes may not be flowed-through more rapidly or to a greater extent than the reduction that would occur under the "average rate assumption method." Under the average rate assumption method, deferred taxes are flowed-through to ratepayers as "timing differences" with respect to public utility property reverse, i.e., as depreciation deductions for book purposes with respect to a particular asset exceed depreciation deductions taken with respect to that asset for Federal income tax purpose. Under the average rate assumption method, excess deferred tax reserves are generally flowed-through to ratepayers in the same pattern and with the same rapidity as those taxes would have been paid to the Federal government had a decrease in tax rates not occurred.

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Description of H.R. 1049

The bill would repeal section 203(e) of the 1986 Act which requires the normalization of excess deferred taxes. Thus, under the bill, there would be no limitations under the tax laws regarding the rate at which excess deferred tax reserves could be flowed-through to ratepayers.

Accounting For Federal Tax Subsidies

In setting the rates that utilities may charge their customers, utility regulators have two basic goals: (1) to establish rates that adequately cover the cost of providing utility service, and (2) to minimize the cost of providing those services.

The rates that utilities charge for services must be sufficient to cover current expenses such as labor, fuel, and taxes, and the cost of acquiring and using capital assets to provide those services. The total costs attributable to the use of capital include a charge for depreciation, as estimated by regulatory authorities, interest payable to creditors, and a sufficient after-tax return to shareholders to maintain and attract equity capital. Stated in another manner, rates are set so that consumers are charged a price that reflects a fair, but not excessive, rate of return to capital.

Thus, under regulatory accounting, the size of the rate base -- that is, the total value of plant and equipment financed by lenders and shareholders -- determines all components of the cost of capital used to produce utility services. The rate of return to lenders and shareholders is some "fair return" expressed as a percentage of the share of rate base they have financed. Depreciation represents the fraction of the rate base used up in each year's production that must be replaced if the service output is to be maintained.

When taxpayers are allowed to use accelerated methods of depreciation for tax purposes, tax depreciation is more rapid than the actual economic or physical deterioration of capital assets and the economic effect is the deferral of tax liability. The result is the same as if the Treasury were to extend a series of interest-free loans to the taxpayers during the early years of an asset's life, which are repayable in the later years. Moreover, this extension of interest-free financing is effectively available to any taxpayer utilizing accelerated depreciation for tax purposes, regardless of whether that taxpayer is operating in the regulated or non-regulated sector of the economy.

Under regulatory accounting practices required by the normalization rules, the deferrals of tax resulting from the use of accelerated depreciation are explicitly recognized as interest-free loans from the government and are termed "deferred taxes," or "reserves for deferred taxes." These reserves for deferred taxes are included in a utility's rate base for regulatory accounting purposes, and thus are viewed as part of the utility's capital structure. In contrast to portions of the rate base composed of equity and interest-bearing debt, deferred tax reserves do not earn a rate of return under regulatory accounting principles because they are viewed as interest-free loans. Thus, the utility's cost of service and the corresponding rates charged to the utility's customers are reduced by virtue of the benefits obtained through this "zero-cost" financing represented by deferred tax reserves.

Normalization is the proper accounting treatment for these interest-free loans because normalization recognizes the economic nature of these tax deferrals and correctly accounts for them as such. By correctly accounting for the tax deferrals generated by the use of accelerated depreciation, normalization helps ensure the effectiveness of these capital incentives provided by

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Congress for the use of both the regulated and non-regulated sectors.

If a procedure other than normalization is applied to accelerated depreciation, the result will be inconsistent with both the Congressional intent underlying the availability of accelerated depreciation and the objectives of equitable rate regulation. If the income tax expenses for which ratepayers are charged are reduced immediately by the capital subsidy inherent in accelerated depreciation -- a procedure commonly called "flow-through" -- current ratepayers will be undercharged for their cost of service while future ratepayers will be required to make up the difference and thus will be overcharged for services.

Under flow-through, current ratepayers are undercharged because they are only charged for the current Federal income tax payments made to the government. Deferred tax liabilities relating to current economic income but payable in later periods are not charged to current ratepayers, but are rather charged to future ratepayers only when the deferred liabilities become due. Thus, future ratepayers are over-charged because they are required to pay a portion of the Federal income tax economically incurred by the utility when it was providing services to current ratepayers.

In contrast, normalization results in both current and future ratepayers being charged for their proper share of the income tax expense incurred by the utility over the economic life of the depreciable property providing utility services to the ratepayers. By treating deferred taxes as interest-free loans, both current and future ratepayers benefit from the reduction in cost of service achieved by the interest-free financing that is used by the utility in lieu of equity and interest-bearing debt that demand a rate of return and thus increased cost of service.

Normalization of Excess Deferred Taxes

Under the 1986 Act, marginal Federal income tax rates were significantly reduced for both corporate and individual taxpayers. The maximum tax rate for corporate taxpayers was reduced from 46 percent to 34 percent, while the maximum tax rate for individuals was reduced from 50 percent to 28 percent. As a result of these tax rate reductions, the deferred tax reserves of utilities are presently overstated. With respect to utilities, such reserves have generally been established in amounts sufficient to fund future tax liabilities based on a 46 percent rate, while under the 1986 Act these future tax liabilities will be based on only a 34 percent rate. Thus, excess deferred tax reserves presently exist on the balance sheets of utilities; the treatment of these excess deferred taxes for regulatory accounting purposes is the focus of both section 203(e) of the 1986 Act and H.R. 1049.3/

In this regard, the normalization rules of section 203(e) differ slightly from previous normalization rules existing before the 1986 Act in that section 203(e) deals with excess tax reserves resulting from the application of tax rate reductions to accumulated deferrals representing previous accelerated

3/ Section 203(e) of the Act does not apply to excess deferred taxes resulting from any decreases in tax rates occurring prior to the 1986 Act, e.g., the decrease in top corporate tax rates from 48 percent to 46 percent under the Revenue Act of 1978 (Pub. L. 95-600). The Internal Revenue Service has issued several private letter rulings holding that accelerated flow-through to ratepayers of the excess deferred taxes created under the Revenue Act of 1978 would not violate the normalization rules in effect at that time.

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depreciation taken by the utility. In contrast, normalization rules in the past have focused on the direct normalization of accelerated depreciation itself. Nevertheless, both types of normalization rules are integrally concerned with the effects of tax deferral from the use of accelerated depreciation on regulatory accounting. In addition, many of the same considerations underlying previous normalization rules are fully applicable to section 203(e).

Normalization of excess deferred tax reserves encourages the equitable allocation of a Federal income tax benefit (the 1986 reduction in tax rates retroactively applied to existing deferred taxes) to the utility's ratepayers over the remaining life of the property to which the tax benefit relates. Such treatment helps avoid the fluctuations in both utility rates and the demand for utility services that would result from the flow-through of the excess tax reserves to early ratepayers on an accelerated basis.

This equitable allocation of tax benefits to all ratepayers over the life of the applicable public utility property is a fundamental goal of the normalization rules. If, in contrast, tax benefits were flowed-through to ratepayers on an uneven and accelerated basis, utility rates for current ratepayers would be too low, leading to overconsumption of utility services and temporary, but unsustainable, growth in the industry output.

We also have some concerns regarding the effect that enactment of H.R. 1049 would have on the nation's capital markets. Utilities would be forced to resort to the capital markets to replace the loss of deferred taxes with additional debt and equity capital. This development would place additional strain on the nation's capital markets at an inappropriate time. In addition, enactment of H.R. 1049 would effectively reduce the nation's aggregate savings because an immediate flow-through of savings in the form of deferred taxes would be spent, in part, on consumption rather than saved in its entirety. We believe that this net reduction in savings would be an undesirable development at the present time. (This is a corollary to our concern that future consumers should not have to pay unwarranted higher prices to support a temporary increase in consumption by the current generation of consumers.)

Enforcement of Normalization Through the Internal Revenue Code

The normalization requirements of the Internal Revenue Code describe how accelerated depreciation (and other tax subsidies such as the investment tax credit) should be accounted for in utility ratemaking while also prescribing penalties for failure to follow the required accounting practices. If the normalization rules are violated, the use of accelerated depreciation for all of the taxpayer's public utility property is completely disallowed. It is worthwhile to explore the reasons for imposing these penalties.

Congress first provided accelerated depreciation in the Code in 1954. By the mid-to-late 1960's, certain problems had developed with regulated utilities. Some regulators were immediately flowing through the benefits of accelerated depreciation, thereby reducing greatly the capital-subsidy effects of depreciation and also benefiting current consumers over future consumers of utility products. The Tax Reform Act of 1969 provided that accelerated depreciation would be available to regulated utilities only if normalization were followed for ratemaking purposes. The Congressional concern was that absent such rules, regulators would flow-through the subsidy, thereby reducing its impact. Other normalization provisions regarding depreciation and the investment tax credit followed the 1969 Tax Reform Act.

Under the 1986 Act, Congress continued the prior normalization rules and also required excess tax reserves attributable to acceleration depreciation of public utility

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property to be normalized over the remaining useful life of the property. By requiring normalization of excess deferred taxes, Congress ensured that inappropriate rate reductions were not provided to current utility ratepayers at the expense of future utility ratepayers.

Although the normalization provisions of the Internal Revenue Code no doubt preempt some element of discretion that would otherwise be left to ratemaking authorities, they furnish regulators with the means to counteract economic and political pressure to keep current rates as low as possible. In order to offset this pressure, stringent rules such as those found in the Code are required. Without such rules, inappropriate flow-through of various tax benefits would prove, in many cases, to be an irresistible force.

Conclusion

The Administration opposes H.R. 1049. We believe that the normalization of capital subsidies, established in the tax laws for almost two decades, represents the correct regulatory accounting method for public utilities. By preventing the improper flow-through of tax benefits to current ratepayers at the expense of future ratepayers, normalization ensures that tax benefits are allocated fairly and uniformly to ratepayers over the life of the public utility property in question. Moreover, the normalization of excess deferred tax reserves ensures that those reserves will affect the prices changed by regulated utilities over time in a consistent and even fashion.

In addition, we believe that H.R. 1049 would have adverse effects on the nation's capital markets caused by the necessity of utilities to replace the capital financing lost by means of the flow-through of deferred taxes to ratepayers occurring under the bill. We believe that under H.R. 1049 utilities would be forced to access the capital markets to obtain new equity and debt capital, thereby reducing the amount of savings available for other capital investment in the economy. In contrast, under section 203(e) of the 1986 Act utilities will flow-through the excess deferred tax reserves in an orderly manner over the life of the utility's plant and equipment.

Finally, we believe that H.R. 1049 would reopen tax reform and perhaps upset the balance of various compromises and agreements that led to the 1986 Act. We believe that it is inappropriate to reconsider a change in the law regarding normalization of deferred tax reserves, which was an important provision in the overall package regarding capital cost recovery contained in the 1986 Act.

H.R. 2792 -- INDIAN FISHING RIGHTS

Description of Present Law

There is no provision in the Internal Revenue Code that exempts a person from payment of Federal income tax on the grounds that the person is an Indian. Thus, it is settled under the laws that, in their "ordinary affairs," Indians are generally subject to the Federal income tax to the same extent as other persons. Any exemption from Federal income taxation must be derived from laws, treaties, or agreements with Indian Tribes or an Act of Congress.

In this regard, the Supreme Court has held that income derived by an Indian from restricted land, held in trust by the Government for the purposes of dividing and allotting the land to members of the tribe after a period of time, is exempt from Federal income tax. Squire v. Capoeman, 351 U.S. 1 (1956). In Capoeman the Court found that Congress intended for tax-exempt status to be granted to income earned from the land while it was restricted and held by the Government in trust, on the grounds that the relevant statutory language indicated that during this

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period of time the land should not be burdened by any debts, including, presumably, debts for the payments of taxes.

Prior to 1871, when the Congress prohibited treaty making with Indian tribes, several Indian tribes entered into treaties with the United States government and several territorial governments that reserved various fishing rights to the Indians. Since then, additional Indian fishing rights have been established by statute, executive order, or agreement later approved by an Act of Congress. Fishing rights secured by various treaties, Acts of Congress, and executive orders have been held to include the right to fish for commercial purposes as well as the right to fish for subsistence purposes. Washington v. Washington State Commercial Passenger Fishing Vessel Ass'n, 443 U.S. 658, 676 (1979).

Two separate judicial decisions have held that income derived by an Indian from fishing rights under a treaty was not exempt from Federal income tax, on the grounds that there was no express language in the treaty providing that income from such fishing rights was to be tax-exempt. In Earl v. Commissioner, 78 T.C. 1014 (1982), the Court held that income earned by an Indian from fishing in waters protected for Indian use in a treaty adopted in 1854 was fully taxable under the Internal Revenue Code. The Court found that there was no language in the treaty conferring exempt status on the income; moreover, the Court found the situation to be distinguishable from the facts in Squire v. Capoean, *supra*, in that the rights of the Indians to fish in the waters in issue were essentially different from the rights of a particular Indian to receive income from allotted lands which were held for him in trust by the Government. Similarly, in Strom v. Commissioner, 6 T.C. 621 (1946), *aff'd per curiam* 158 F. 2d 520 (9th Cir. 1947), the Court found that income earned from fishing in a river within a reservation was subject to Federal income taxation because the applicable treaty, adopted in 1855, did not expressly provide for any such tax exemption.

The Interior Department has supported granting tax-exempt status to income earned from Indian fishing rights, and has disagreed with interpretations of present law holding that income was not tax-exempt in the absence of express language in the applicable treaty or governing authority.

Description of H.R. 2972

H.R. 2792 would amend section 2079 of the Revised Statutes (25 U.S.C. 71) to provide that any income derived by an Indian from the exercise of rights to fish secured by any treaty, executive order, or statute shall be immune from Federal, State, and local income taxes. H.R. 2792 would apply to any period for which the statute of limitations or any other bar to assessing tax has not expired.

Discussion

The Treasury Department recognizes that the issue of taxation of income derived by Indians from exercise of their fishing rights is of great concern to Indian tribes throughout the country, and particularly to several Northwest Indian tribes. As previous testimony from the Department of Interior has indicated,^{4/} at the time these various Indian treaties were signed, many tribes reserved the right to fish in perpetuity. The Indians who were parties to the treaties understood that they would be able to continue to fish (and trade fish) on the same basis as they had before the signing of the treaties, when they

^{4/} Statement of Ross O. Swimmer, Assistant Secretary for Indian Affairs, Department of the Interior, Before the Hearings of the Select Committee on Indian Affairs, United States Senate, on S. 727, a Bill "To Clarify Indian Treaties and Executive Orders With Respect to Fishing Rights," March 27, 1987.

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neither were required to pay taxes nor to turn over any portion of their catch to the Federal government. H.R. 2792 would embody this understanding in the law by providing a tax exemption for Indians with respect to income derived from exercise of their fishing rights in situations where the exempt nature of those rights was not expressly granted in a treaty or other applicable authority.

The Administration supports H.R. 2792, while also believing that the bill should be narrowly construed to the issue of fishing rights, and not serve as a precedent for conferring tax-free status to all income derived by Indians from resources that may be covered by treaties. We have been informed by the Department of the Interior that the income derived from the exercise of fishing rights is minimal, with much of that income being earned by Indians below or near the tax threshold. Moreover, we understand that fishing serves a number of unique and important functions in Indian cultural and religious life, and thus may be distinguished from other types of activities engaged in by Indians that would remain fully taxable under H.R. 2792.

The Treasury Department would also like to raise certain administrative issues with respect to H.R. 2792. First, officials from the Department of Justice have informed us that they believe the bill is unclear with regards to its effect on both settled and pending litigation involving the taxation of Indian fishing rights. We believe it would be desirable to provide additional clarification regarding the effect of the bill on this litigation. In addition, we believe it is unclear as to whether H.R. 2792 applies to FICA and FUTA taxes (where otherwise applicable) on Indian income from fishing rights; we suggest that this issue be similarly considered and clarified before enactment of any final legislation. We suggest that care be taken to ensure that any exemption from FICA and FUTA tax does not work to the detriment of the affected persons. In addition, we would like to note that H.R. 2792 may require potentially burdensome allocations between fishing and non-fishing income in order to determine the proper amount of taxable income earned from activities that remain fully taxable under the bill.

Finally, the Treasury Department believes that the proposed tax exemption for fishing rights does raise important issues of tax policy, since H.R. 2792 would result in uneven taxation of Indians who exercise fishing rights and Indians or other individuals who derive income from non-exempt activities. Moreover, other provisions in the tax laws, such as the earned income tax credit, the personal exemption, and the standard deduction, already serve to exempt low-income persons from taxation and to promote equitable tax treatment between Indians who fish and those who engage in other occupations.

HOUSING ALLOWANCES FOR THE U.S. MISSION TO THE U.N.

Description of Present Law

Section 912(1) of the Internal Revenue Code excludes from the gross income of officers and employees of the government certain allowances, such as housing allowances, received pursuant to the Foreign Service Act of 1980, the Central Intelligence Act of 1949, the Overseas Differentials and Allowances Act, and the Administrative Expenses Act of 1946. The Government officers and employees eligible for these allowances are all stationed outside the United States (other than Alaska).

Pursuant to sections 8 and 9 of the United Nations Participation Act of 1945, as amended (codified at 22 U.S.C. 287e and e-1) the State Department provides cash housing allowances (or the subsidized lease or rental of living quarters) to the:

- (i) Representative and Deputy Representative of the United States

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to the United Nations (U.N.) in New York, (ii) delegates and representatives of the United States to the U.N., (iii) members of the Foreign Service assigned to the U.S. Mission to the U.N., and (iv) certain designees of the Permanent Representative and the Secretary of State assigned to the U.S. Mission. As the United Nations Participation Act is not mentioned in section 912(1) of the Code, the allowances and value of any living quarters provided by the U.S. Government to the aforementioned persons are not excludible from gross income under section 912.

5/ Under the current Standardized Regulations of the State Department, the allowances and the value of the housing are listed as not subject to U.S. income tax.

Description of Proposal

The proposal being considered would amend section 912(1) of the Code in order to exclude from the gross income of employees of the U.S. Government housing benefits provided under sections 8 and 9 of the United Nations Participation Act. This provision to amend the Internal Revenue Code is being proposed within the context of several amendments to the United Nations Participation Act under consideration in the Foreign Relations Authorization Act, Fiscal Years 1988 and 1989 (H.R. 1777), now in Conference.

Discussion

The Treasury Department has concerns about this proposal for the reasons set forth below.

The eligibility for exclusions under section 912, including any exclusion for housing allowances, has historically been limited to Government officials and employees stationed outside the continental United States. This rationale for such limitation is that section 912 is designed to provide benefits to Government employees comparable to those provided to private sector employees under section 911 of the Code. Under the latter section, only housing allowances for foreign housing are excludible from gross income, based on the theory that such tax-free allowances encourage employment of Americans abroad who will promote U.S. exports.

If the section 912(1) exclusion were extended to government employees stationed at the U.S. Mission to the U.N. in New York, it would no doubt soon be argued that the exclusion should be extended to other government employees in New York. And, since the exclusions under sections 912 and 911 are designed to be roughly comparable, some might plausibly argue for exclusions for housing benefits provided to private sector employees living in New York and other places in the United States with high housing costs. In such a situation, the basic tax principle that housing costs are paid from after-tax income would be significantly undermined.

5/ It is possible, however, that the allowances and the value of living quarters may be excludible from the gross income of the employee or officer under section 119 of the Code as the value of lodging furnished to him by or on behalf of his employer. In addition, it is also possible that the employees and officers may deduct from gross income costs incurred by them for housing under section 162, as a traveling expense while the employees and officers are away from home in the pursuit of a trade or business. The determination of the exclusion of amounts from gross income under section 119, or the deduction of amounts under section 162, would be made on the basis of the facts and circumstances surrounding each individual employee's or officer's situation. See e.g., Revenue Ruling 83-82, 1983-1 C.B. 45.

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We recognize that the high cost of housing in New York creates difficulties for the State Department in recruiting talented individuals to serve in the U.S. Mission to the United Nations. Moreover, we especially appreciate the problems that State Department personnel face with regards to potential tax liabilities resulting from the receipt of these housing allowances in past years; allowances the employees were told were tax-free. In any case, we have committed to work with the State Department, the Office of Management and Budget, and the Office of Personnel Management to derive an overall compensation package for employees assigned to the United Nations that would address these legitimate concerns within a framework of sound tax policy and even-handed treatment of all taxpayers under the law.

Chairman RANGEL. Yes. But your basic position is that if passed, these tax benefits to the consumer, it would encourage consumption?

Mr. STEUERLE. Mr. Chairman, the tax benefits will be passed through to the consumer in any case. Our concern is that they not be passed through immediately, so that we promote overconsumption in the early years, and then force later consumers to have to pay a higher price for services.

Chairman RANGEL. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman. Mr. Steuerle, I am interested in the position Treasury has taken. I wonder if you could describe for me how this position squares with the new federalism that the President talks about, providing the opportunity for States and local governments to make their own decisions.

The Treasury Department's position is a turnabout from past Federal practices and would handcuff State regulators.

How does that square with new federalism?

Mr. STEUERLE. Mr. Dorgan, we believe that the federalism issue applies to the activities of States in dealing with their own particular problems, their own circumstances, their own ratemaking. In the case of normalization, we are talking about a Federal tax benefit, and generally, the Federal Government does have the right to determine how those Federal tax benefits will be used.

Generally, for instance, when we applied investment credits or accelerated depreciation to utilities, we determined that those benefits should flow through to consumers over time. The purpose of those benefits was, indeed, to increase investment in plant, so that future consumers would benefit from them. We think that normalization followed a similar pattern. We are simply stating how we wish those Federal tax benefits to be used.

Mr. DORGAN. Has the Treasury changed its position on this matter, or is this something that you have consistently followed over time?

Mr. STEUERLE. Since 1969, Congressman Dorgan, we have taken a position in favor of normalization.

Mr. DORGAN. I understand that, but as I said in the opening statement, I am not talking about normalization. I am talking about excess-deferred taxes that now are not owed to the Federal Government.

That is different from the description you have given us of normalization. I ask whether you have changed your position on this matter because the Treasury did not insert in its own tax-reform proposal package anything like section 203(e). If this is something that you feel is necessary and important, why would it have been omitted from Treasury's own tax package?

Mr. STEUERLE. Congressman Dorgan, I was intimately involved in—in fact, in charge of, the original organization and design of Treasury I, and I can tell you that there were many issues that we did not have time to cover in putting forth that study. That study was followed by Treasury II, the Ways and Means Committee bill, and the Senate Finance Committee bill. There were many details that we did not have time to get to. In no way was there a decision made in Treasury I not to include normalization. In fact, toward the end of the period of time for the study, several people ap-

proached me and said we need to put something in. We were simply running out of time to cover this and other issues.

Mr. DORGAN. In fact, Edison Electric had written Treasury a letter on February 5, 1985—which I have a copy of—that made the case for normalizing excess deferred taxes. I assume that Treasury considers these kinds of suggestions from taxpayers, and groups, and organizations, and you either accepted it or reject it.

Apparently, since you did not put it in the tax package, you considered it and rejected it. Can you give us some information about that?

Mr. STEUERLE. Mr. Dorgan, there were thousands of issues that we had to deal with. We dealt with as many as we could. Normalization was one of those issues we felt we could deal with later on, through drafting.

Again, I would like to point out that, at the time Treasury I came out, it was a study that was not a bill or a proposal. The President had not formally put forward a proposal.

In Treasury II, as you may recall, we did actually propose the recapture of the benefits of accelerated depreciation to taxpayers. The benefits of pulling those back, and giving them to Federal taxpayers would lower the Federal debt, which would lower interest cost over time, and also benefit consumers, or taxpayers over time.

Mr. DORGAN. Does the Treasury now believe then that earlier private letter rulings which blessed the practice of flowthrough for excess deferred taxes is incorrect?

Might I combine that with a question about the 1978 reduction in the corporate income tax, in which Treasury did not come forward and propose something similar to 203(e) for the excess deferred taxes.

Can you describe to me, in both conditions, why Treasury was not taking a position then in opposition to flowthrough?

Mr. STEUERLE. With respect to the rulings, Congressman Dorgan, the rulings simply interpret law. The rulings are not meant to make the law.

We have a law, now, in the 1986 act, which we will apply through the proper rules. Where rules allow flowthrough, we do not derive rules, or make law through rulings. With respect to the drop in the corporate rate from 48 to 46 percent, it simply was a very small rate reduction, and we simply did not feel that it was necessary for that small of a rate reduction to deal with the issue.

Mr. DORGAN. So you did not have a change in attitude, you just thought that the drop in rates then was so insignificant that you chose not to deal with it? Actually, the issue here is quantity. The magnitude of the tax-rate decrease is what propels Treasury to be involved in 203(e).

Mr. STEUERLE. I think our position is consistent over time, Congressman Dorgan, with respect to normalization, and with respect to how we wish the benefits of accelerated depreciation and grants to flow through.

The 1978 rate reduction was a small item, and it simply was not considered to be of large enough size to make a significant difference.

Mr. DORGAN. If I might ask one further question, Mr. Chairman.

Does it give you pause to read in the paper, that a utility company forms a holding company and purchases an insurance company, or a drug chain, and ostensibly uses some of the cashflow that is available from this interest-free financing that you have described to us, to accomplish that? Does that give you concern?

Mr. STEUERLE. Congressman Dorgan, any time a plant is depreciating, a company, whether a regulated company or a nonregulated company, accumulates cash which then has to be invested. It has to be invested in one item or another.

At the time that the plant is fully depreciated, the plant has to be replaced. If a company did not build up reserves with which to replace the plant, then what it would have to do, especially in a regulated environment, is to charge future consumers not only for the cost of the new plant, but all the remaining debt, and interest costs on the old debt that were applicable to the old plant. It is quite common in both the regulated and nonregulated environment for companies to build up reserves to cover the decline in value due to depreciation.

Mr. DORGAN. Well, I understand that, but that wasn't my question. Utilities are regulated monopolies. Treasury takes the position that 203(e) is important, and that normalization is important in order to offer interest-free financing for the purpose of providing the public services by utilities. Does it give you concern, or give you pause to learn that some utilities, at least with respect to some companies who are cash flush, are using that financing not to provide greater service to customers, but to go off and buy a drug store chain?

Does that give you concern?

Mr. STEUERLE. Treasury does not believe that it should be in the business of telling the regulatory agencies exactly how those cash reserves should be used.

It does believe that the buildup of cash reserves——

Mr. DORGAN. Now, wait a minute. What does 203(e) do?

Mr. STEUERLE. Section 203(e) deals with the allocation of a Federal tax benefit to consumers over time.

Mr. DORGAN. Does not 203(e) prevent the State regulatory bodies from doing something? In other words, aren't you telling the State regulators how to operate with 203(e)?

Mr. STEUERLE. With respect to a Federal tax benefit.

Mr. DORGAN. So the position of Treasury is at times you are willing to tell them things, and then other times you are not in the business of telling them things?

Mr. STEUERLE. We believe the Federal Government does indeed tell companies how certain Federal tax benefits should be used.

Mr. DORGAN. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Vander Jagt.

Mr. VANDER JAGT. Thank you, Mr. Chairman, and thank you, Mr. Secretary, for your statement. I think you gave good arguments for your position.

Parenthetically, I admire your courage. Treasury I met with such a firestorm of opposition that it was quickly replaced with Treasury II. We cannot find many people around town who claim parentage of Treasury I, and I commend you for that.

I happen to believe it started us on the road that led to the 1986 Tax Reform Act, so maybe——

Chairman RANGEL. It sure did.

Mr. VANDER JAGT. So maybe it does not take as much courage to admit that as I gave you credit for.

Well, if H.R. 1049 were enacted, what would be the impact on Federal tax revenues, one way or the other?

Mr. STEUERLE. We have not done a revenue estimate on this Mr. Vander Jagt. We are not sure whether there is a significant impact, one way or the other, but we are looking into the issue.

Mr. VANDER JAGT. Do you have any guesses?

Mr. STEUERLE. Not at this time.

Mr. DORGAN. Would the gentleman yield.

Mr. VANDER JAGT. I would be happy to yield.

Mr. DORGAN. The Joint Tax Committee, I think as Mr. Steuerle probably knows, has issued its opinion, and it says there is no significant impact on Federal revenues.

Mr. VANDER JAGT. Do you have any quarrel with the Joint Tax Committee's study?

Mr. STEUERLE. We have no quarrel with their basic analysis. The Joint Tax Committee has done an estimate on the primary effect of this bill and determined there is no revenue effect. There are some secondary issues, which could have a revenue effect, that we are trying to look into.

Mr. VANDER JAGT. Thank you very much.

Mr. ANDREWS. Would the gentleman yield for just one quick question.

Mr. VANDER JAGT. I would be happy to yield.

Mr. ANDREWS. When will Treasury complete its study? You say you are looking into it. When are you going to finish your study, and your review?

Mr. STEUERLE. We still have this issue under review. I am not quite sure. We have no study mandated here. Do you wish a revenue estimate? Is that it, Mr. Andrews?

Mr. ANDREWS. Yes. I thought you said you were looking into what kind of revenue ramifications there are. Is that the case?

Mr. STEUERLE. There are a number of issues, debates that are going on as to some of the secondary effects of this change. The primary effects of normalization rules have generally been determined not to have a revenue impact.

Mr. ANDREWS. All right. So you are not doing a study?

Mr. STEUERLE. We always continue to examine our revenue estimates. We have no study mandated. We have no output that Congress has requested, say, in the next month or two. We always continue to look at our revenue estimates.

Mr. ANDREWS. Thank you.

Mr. VANDER JAGT. Thank you, Mr. Secretary.

Chairman RANGEL. Mr. Coyne.

Mr. COYNE. No questions.

Chairman RANGEL. Mr. McGrath.

Mr. McGRATH. Thank you, Mr. Chairman. And I want you to know that Treasury did not write my opening statement. [Laughter.]

Although they reflect some of my concerns.

I really have no questions Mr. Steuerle at this point.

Chairman RANGEL. All right, Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. Steuerle, I was interested in your responses to earlier questions. Can you restate for me why it is you feel the Treasury or the Federal Government should help people decide how they spend their tax benefits?

Do you see that as a proper function of the Tax Code?

Mr. STEUERLE. Mr. Brown, when the Federal Government provides incentives such as the investment credit and accelerated depreciation, it automatically is encouraging taxpayers to engage in certain behavior. If you invest, the Federal Government will provide certain benefits. The value of those benefits will thereby be made available to consumers over time because of the increased value of that investment.

In a regulated environment, the Federal Government is simply trying to do the same thing. The value of these benefits should be made available to consumers over time, that this is the intent of those Federal tax benefits. If the Federal Government were not providing the tax benefits in the first place, it would not be mandating how those benefits should be spent.

Mr. BROWN. So you see the providing of benefits and the guidance therefrom as a proper function of the Federal tax system?

Mr. STEUERLE. With respect to the Federal tax benefits the Federal Government provides, yes.

Mr. BROWN. What's the justification for this particular tax benefit?

Mr. STEUERLE. Are you referring to normalization in general, or to the particular reduction in rates provided in 1986?

Mr. BROWN. The particular reduction in tax rates for 1986 that relate to—

Mr. STEUERLE. Well, when the plan was built, it was built using accelerated methods of depreciation that were provided by the Federal Government. Accelerated depreciation provides a benefit to consumers over time. That was the intent, we believe, of these tax preferences. We believe that intent, as reflected in the treatment of these loans, for instance, as interest-free loans, and allocated over time, is to help consumers over time. It was not intended to provide an immediate reduction in taxes or in benefits to consumers. For instance, the investment credit was not intended simply to flow through immediately to consumers in cash flow, and then the next year be followed by a large increase in utility rates. Instead, the intent was to flow through the tax benefit over time.

Similarly, this reduction in rates from 46 to 33 percent did provide a one-time windfall, but that windfall was related to the benefits that had been provided in the tax code. We believe those benefits again should be provided to consumers over time, because that was the original intent. They should not be spent by current consumers to the detriment of future consumers.

Mr. BROWN. So I take it you are saying it was not an effort to assist the companies involved?

Mr. STEUERLE. Mr. Brown, if you look at utility ratemaking, the equity owners of utilities, because they are regulated, are really much closer to bond holders than they are to almost any other type

of asset holder. The benefits that would be provided, whether under Mr. Dorgan's bill or under the 1986 act, are all intended to go forward to consumers.

The equity holders are regulated so that they receive a certain return over time. If you flow through the benefits immediately to consumers, what will happen is that the utilities will be forced to go out to the capital markets, replace some of that excess tax reserves with equity and debt. But that equity has dividend rates associated with it and debt has interest cost associated with it. That new interest and those dividends will be paid by future consumers.

So it is not a matter of favoring equity holders either under the 1986 act, or under Congressman Dorgan's bill. It is basically a question of which consumers should benefit from the change in the 1986 act. We believe it is consumers over time who should derive the benefits.

Mr. BROWN. Thank you.

Chairman RANGEL. Mr. Coyne.

Mr. COYNE. I have no questions.

Chairman RANGEL. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman.

Tell me—I would like you to expand a little bit—regarding your previous answer to Mr. Dorgan's question, how is this not an interest-free loan to utilities? And were you suggesting, in response to Mr. Dorgan's question, that utility companies do not use deferred taxes to diversify, to buy insurance companies?

Mr. STEUERLE. As I explained, there is a slight difference between the 1986 act and previous normalization rules.

Previous tax benefits from accelerated depreciation were essentially interest-free loans. Since they are interest free, the value of the loan was essentially the value of the interest. It did not have to be paid by the utility.

Essentially, that interest rate is flowed through to consumers, because it does not have to be paid by utilities. By having these accelerated depreciation allowances, utilities do not have to pay dividends to equity holders or interest to bond holders. Therefore, they flow through the value of that interest to consumers.

In 1986, the Congress not only changed the law with respect to accelerated depreciation, but also in effect forgave part of that loan; that is, part of this loan does not have to be repaid to the Federal Government.

Therefore, under the 1986 act, the part of the loan that does not have to be repaid is allocated out to consumers over time, in the same manner as the benefits of accelerated depreciation were originally intended to be allocated to consumers over time. So essentially it is a follow through on the intent of the accelerated depreciation allowances, to flow through these benefits to consumers.

Again, it is not a benefit to equity holders, one way or the other, no matter which way Congress would go on this particular bill.

Would you repeat your second questions, Mr. Andrews?

Mr. ANDREWS. Well, I am curious—did you say in response to Mr. Dorgan's question, when he was asking you about the diversification issue, that deferred taxes are not used for diversification?

Is that what you were suggesting in your answer to him, when he used the illustration of a company, a utility company, that went out and bought an insurance company?

Mr. STEUERLE. Perhaps I could give a very simple answer, Mr. Andrews. Suppose a utility bought a plant for a billion dollars. And suppose this plant functioned without any maintenance for 10 years. And at the end of 10 years it collapsed and we had to replace the plant with a new plant.

Now, originally, we purchased this plant for a billion dollars, say with bonds and equity. Over time, what one wants to do is to make sure that the depreciation on that plant is covered in terms of the rates paid by current consumers, so that at the point in time, year ten, when you are done, you do not pass on to future consumers, who now have to build a new plant, all the costs that were associated with the old plant. During that period of time that you have depreciation of a plant, all companies, whether utilities or anyone else, have cash reserves which are meant to cover the value of that depreciation.

What I responded to Mr. Dorgan is that I do not believe the Federal Government generally told companies how they should invest those particular reserves. That is, we did not determine whether those reserves are invested in bonds or in insurance companies.

Now, perhaps there may be a case, in certain states, or in certain jurisdictions, for the regulatory authorities to worry about this. Perhaps they don't want this money invested in certain ways. But that is not a Federal concern, how the investment is made. Regardless of how it is made, these companies, because they build up these reserves for depreciation, are going to have to invest them in something.

And so it's basically a question, if you don't want them to diversify into insurance companies, do you want them to diversify into something else. They have to invest the reserves in something.

Mr. ANDREWS. Thank you. Thank you, Mr. Chairman.

Chairman RANGEL. I know Mr. Chandler has just arrived, but I will ask a couple of questions, then at that time if you seek recognition, the Chair will recognize you.

Mr. Secretary, do you not see a windfall forgiveness as it relates to the excess deferred tax as a result of the change in the corporate tax structure from 46 to 34 percent?

Mr. STEUERLE. Generally, there is a windfall. In the unregulated companies, of course, the windfall is not forced to be passed forward to consumers, but in fact, is maintained by the company itself.

In the case of a regulated company, that is not true. Equity holders essentially are treated almost like bondholders. They are given a rate of return which is intended by the regulatory authorities to be held fairly constant over time, or to be adequate to be able to get the financing that the companies need. Therefore, in the regulated environment, the Federal Government is not giving this windfall. We are passing it forward to consumers.

The only real question is whether this windfall is passed to current consumers immediately, or whether it's allocated to consumers over time.

But yes, there is a windfall.

Let me also respond, however——

Chairman RANGEL. Did you figure this out in Treasury, that you when you reduced the corporate rates that you had expected that you were increasing the benefit to the consumer over a longer period of time?

Did you not think of the changes in the reserves, in terms of the change in the corporate rates?

I mean, was this an intention on your part to spread out this windfall over a longer period of time? Or did you think about the consequences of the tax act, and then decided in favor of protecting the consumer in the long extent and the short run?

Mr. STEUERLE. Well, Mr. Rangel, if you are asking about the history of Treasury I, Treasury II, and so on and so forth, the——

Chairman RANGEL. No, I am just trying to find out when Treasury reached the position that it is testifying to today; that is all.

Mr. STEUERLE. Mr. Rangel, our testimony today is consistent with our position over the past 20 years. My only point was——

Chairman RANGEL. I guess what I'm asking is, when the tax rate was reduced, did that cause you to take a look at your position as to whether or not it would be a windfall, and how that windfall should be used?

Mr. STEUERLE. In Treasury II, as you may recall, we did address the issue of windfall, and indeed, proposed to the Congress a windfall tax which Congress rejected.

I think one reason that it was rejected is that at the same time there is this windfall with respect to past depreciation allowances, it was also recognized that there was a slight increase in the cost of capital on future investment.

And it was decided that it was therefore inappropriate to apply that windfall tax, because the act also slightly increased the cost of capital for future investment, which also applies to utilities.

But Treasury did address this issue in Treasury II. It was an issue of much concern, both to the administration and the Congress.

Mr. McGRATH. Would the gentleman yield on that?

Chairman RANGEL. Yes.

Mr. McGRATH. I wonder whether, as we have been talking about this windfall as a result of the reduction in the rates, if this windfall has been quantified, in terms of the reduction of the rates vis-a-vis the loss of investment tax credit, the stretching out of depreciation, and changing of some of the classifications of depreciation on some of the equipment used by some of these utilities and others?

Mr. STEUERLE. Well, we have done two separate calculations, Mr. McGrath. On the one hand, we have calculated the cost of capital in the utility sector. We believe the cost of capital there will rise—this is cost of capital for a new investment—by a few percentage points.

With respect to the amount of dollars involved in terms of these excess tax deferred accounts, it is somewhere between \$15 to \$18 billion, according to our estimates.

Mr. McGRATH. Thank you.

Chairman RANGEL. What was your question that got the \$18 billion response?

Mr. McGRATH. I will give you an \$18 billion question.

Mr. STEUERLE. It was the amount of excess tax reserves with which we are dealing.

Mr. McGRATH. It was the reduction of the rates vis-a-vis the loss of some tax preferences, what was the quantifying—

Chairman RANGEL. And there is an \$18 billion difference?

Mr. STEUERLE. No, I was not speaking to the difference. There is approximately \$15 to \$18 billion according to our estimates of excess tax reserves; that is, the amount of tax reserves of which we are speaking today.

On the other hand, what I also commented was, with respect to new capital for utilities, in fact, the cost of capital has risen slightly because of changes in depreciation allowances.

I might comment that that slight increase in cost of capital again means that as we get down the road and start replacing utility plant, that that may mean a slightly higher cost to future consumers also, simply because of the higher cost of capital for new plant and equipment.

It just gives us another reason, or another pause, not to try to lower cost in the short term, only to have cost rise in the long term, both because we gave the benefit of these excess tax reserves away—

Chairman RANGEL. This is an extension of your consumer benefit theory, then? You will be lowering the rates in the future by allowing the utility to hold on to the so-called excess now?

Mr. STEUERLE. That is right. We believe that the rates should be reduced in a uniform fashion.

Chairman RANGEL. So if you allow them to increase their withholding, well—

Mr. McGRATH. Would the gentleman yield for a moment?

Chairman RANGEL. Yes.

Mr. McGRATH. I am not sure I got my question answered. Vis-a-vis the loss—as I understand the excess profit or windfall profit due to reduction of the rate is \$18 to \$19 billion.

Mr. STEUERLE. This is the amount of excess reserves we are talking about in the regulated environment.

Mr. McGRATH. Now, the question I tried to get an answer to was, when you apply the loss of the investment tax credit, and stretching out of the depreciation schedules, and changing of classes of schedules for different kinds of equipment, is there a sum to that?

Mr. STEUERLE. I'm not sure the two can be added, Mr. McGrath. As I say, equity holders in utility companies are essentially provided a rate of return which is somewhat similar to that provided to bond holders. So, it is not a matter of them gaining or losing by the change in the cost of capital, or by the question of how we treat this windfall amount. The real question is simply how we treat consumers.

Mr. McGRATH. Would you agree that it costs them more to do business as a result of the changes in accelerated depreciation and investment tax credit irrespective of the reduction in rates at this point?

Mr. STEUERLE. For new plant and equipment, yes. There will be a slight rise.

Mr. DORGAN. Will the gentleman yield to me?

Mr. McGRATH. Yes.

Mr. DORGAN. I think the point that Mr. Steuerle is trying to make is that whatever the taxes are, whatever the deductions or the rates are, under a regulated environment, the state regulatory commissioners allow that utility company to collect all their costs plus a profit. And the costs include whatever that tax burden is going to be.

But I wanted to just follow up on the chairman's question. I think what I heard you say is that Treasury's position has been consistent since 1969 on this issue.

And I think we should have the record note that at least in 1978, the Treasury Department allowed the flowthrough; in other words, they did not say anything about normalizing the excess deferred taxes. So apparently then they either didn't care or were not involved.

In Treasury I or II, I think Treasury changed its mind and said in fact the company should be forced through the windfall tax, through the recaptured tax, on the excess deferred taxes, to pay that back to the Treasury.

That is obviously a 180 degree departure, is it not, from what Treasury had previously believed.

Now, I think the Treasury has changed from that position to saying, that position was wrong, and we are back where we were in 1969.

So I mean if someone had been in a coma for 20 years, they might wake up and say, you have not changed your mind have you? But in fact, there have been apparently a couple of mind changes down at Treasury on this subject.

Chairman RANGEL. Well, the change was due to consumer protection interests, right?

Mr. STEUERLE. Mr. Rangel, I do not believe that we have changed our mind. We have testified quite a number of times on the issue of normalization.

With respect to the drop in the rate from 48 to 46 percent, the issue was not addressed at that time, because of the small amount of change.

However, when it comes to Treasury I and Treasury II, it was simply an issue that we had not gotten around to. There were quite a number of issues, as I am sure the Congress is well aware, where we had not completed our analysis of the issue.

We did not propose a complete draft bill to the Congress. We had not worked out all the details. We put forward a study, which was then developed over time. And we added provisions over time in cooperation with the Congress.

I do not think that is at all inconsistent. And I was there. There was absolutely no decision at Treasury not to deal with this issue. We had just not gotten around to it.

Chairman RANGEL. These long term interests in the consumer, I assume you did not reach out to any consumer groups before you reached this decision?

Mr. STEUERLE. Mr. Chairman, I think again, once again, that we believe that what we have done here is in the best interests of consumers over time.

We are not saying that certain consumer groups would not favor a lowering in rates in the short run at the cost of having higher rates to consumers in the long run.

But certainly——

Chairman RANGEL. Were there any consumer groups that wanted lower rates in the long run, and were ready to forfeit lower runs in the short run? I mean, consumer groups I assume did not take one position, since you wanted to reflect their views.

Mr. STEUERLE. I cannot speak to the opinion of all the various consumer groups.

Chairman RANGEL. No, can you speak to the opinion of any one of them? My question was, did you reach out to any consumer group before you reached this position?

Mr. STEUERLE. Mr. Chairman, our position on normalization has been consistent over time, and we have put it forward to a number of groups, indicating that we think this is a fair method of accounting, which is fair to consumers——

Chairman RANGEL. I do not have any problem at all with your testimony. I was just asking whether included in that group that you reached out to, were there any consumer groups?

Mr. STEUERLE. Mr. Chairman, we have received a number of comments from consumer groups. And we have given them our opinion, and they have given us theirs.

Chairman RANGEL. This secondary study that you are doing that relates to revenue, could you tell us to which area the secondary study is directed?

Mr. STEUERLE. Mr. Rangel, I just merely meant to indicate that we continue to review our revenue estimates.

There are a number of questions having to do with such questions as whether utilities may pay estimated tax on a faster basis than other companies; such questions as whether there is an indirect or secondary effect with respect to how flowthrough of normalization could affect excise tax revenues. These are generally secondary questions that are not taken into account in revenue estimating, and that is the reason we are continuing to look at them, but we have made no decision as to whether to incorporate them into the revenue estimates.

Chairman RANGEL. If this bill passes, do you have any idea as to what the increase in consumption of power would be?

Mr. STEUERLE. Yes, Mr. Chairman. I believe that we believe that the rates would generally be decreased by about 3 percent.

Chairman RANGEL. Well, it is not the rates. I am really concerned with whether or not as a result of determining what the rate decrease would be, have you any idea what the rate of consumption would be?

Mr. STEUERLE. It would probably be on the order of a 2- or 3-percent increase in consumption, I would guess, given that rate increase.

Chairman RANGEL. Well, consumption; is that normally connected with the rate of purchase of electric appliances and big ticket items? Or is there any relationship between increased consumption and increased purchasing?

Mr. STEUERLE. Generally, the rate of consumption is related to the price. If you lower the price immediately, you will increase the consumption immediately.

And then when you raise the price later, you will lower the consumption.

Chairman RANGEL. This increase in consumption, would that in any way increase the taxes and increase revenues?

Mr. STEUERLE. Again, this is on the order of secondary effect. What you really do is shift consumption from one type of company to the other. That is the reason the primary effect is not to change revenues.

The change in this method of accounting does not necessarily, in the first instance, change GNP. What it does is, it changes relative amounts of consumption. So you may get slightly more consumption by utilities; slightly less equity would be floated by nonutilities while more equity would be floated by utilities.

It is still secondary order questions that may arise. But generally, we do not believe that overall consumption—overall GNP would change.

I should indicate, though, to qualify that remark, that we are concerned that a stock of saving would be flowing out in the form of lower rates. We are concerned about another secondary effect, a decrease saving in the economy, because a stock of saving or assets would be flowed through to individuals, just as if you gave an income tax reduction, and flowed it through to individuals.

We would assume some amount of that would be consumed. And therefore, the stock of saving would decrease, which would have some sort of effect over time, also.

Chairman RANGEL. Well, when we reduce the individual taxes and reduce the corporate taxes, we had hoped that the consumer, or the individual taxpayer, would be the beneficiary. And I can see where that type of thinking, at least in the short run, would not apply to the reduction of corporate taxes here.

In other words, you would want the individual tax payer to receive the benefit in a longer period of time.

Mr. STEUERLE. Mr. Chairman, I think when we reduce tax rates, we also exchange this for better methods of treating depreciable capital, so that decisions by consumers would be more balanced; that is, the price would more closely reflect the true social cost.

I think that the same thing is taking place here. We are concerned that you not lower the price of utility services in the short run below the social cost of providing those services, so you get an over consumption in the early years, which will be paid for by future rate payers.

Chairman RANGEL. This national view that you are taking in terms of the protection of the utility companies in the long run, I assume that you have had some studies that you can make available to this committee?

Mr. STEUERLE. We have a number of previous studies. We will be glad to supply whatever you request for the record, Mr. Chairman.

Chairman RANGEL. Thank you. Are there any other questions that members may have as it relates to this part of the Secretary's testimony?

If not, then I would ask you to proceed with the Indian fishing rights section of the presentation.

Mr. STEUERLE. Thank you, Mr. Chairman.

There is no provision in the Internal Revenue Service Code that exempts a person from payment of Federal income tax on the grounds that the person is an Indian. Indians are generally subject to the Federal income tax to the same extent as other persons. Any exemption from Federal income taxation must be derived from laws, treaties or agreements, with Indian tribes, or an act of Congress.

H.R. 2792 would provide that any income derived by an Indian from the exercise of rights to fish secured by any treaty, Executive order, or statute shall be immune from Federal, State, and local income taxes.

The Treasury Department recognizes that the issue of taxation of income derived by Indians by exercise of their fishing rights is of great concern to Indian tribes.

At the time these various Indian treaties were signed, many tribes reserved the right to fish in perpetuity. The Indians who were parties to the treaties understood that they would be able to continue to fish on the same basis as they had before the signing of the treaties, when they neither were required to pay taxes, nor to turn over any portion of their catch to the Federal Government.

H.R. 2792 would embody this understanding. The administration supports H.R. 2792 while also believing that the bill should be narrowly construed to the issue of fishing rights, and not serve as a precedent for conferring tax-free status to all income derived by Indians for resources that may be covered by treaties.

We have been informed by the Department of the Interior that the income derived from the exercise of fishing rights is minimal.

Moreover, we understand that fishing serves a number of unique and important functions in Indian cultural and religious life.

The Treasury would also like to raise certain administrative issues with respect to H.R. 2792. We believe it would be desirable to provide additional clarification regarding the effect of the bill on existing litigation.

In addition, we believe it is unclear as to whether H.R. 2792 applies to FICA and FUTA taxes. We suggest that care be given to ensure that any exemption from FICA and FUTA tax does not work to the detriment of affected persons.

Finally, the Treasury Department believes that the proposed tax exemption for fishing rights does raise important issues of tax policy, since H.R. 2792 would result in uneven taxation of Indians who exercise fishing rights, and Indians or other individuals who derive income from nonexempt activities.

Other provisions in the tax laws, such as the earned income credit, the personal exemption, and the standard deduction, already serve to exempt low income persons from taxation.

That concludes my oral remarks, Mr. Chairman.

Chairman RANGEL. Are there any members that seek to question the Secretary on the Indian tribe rights?

Mr. Chandler.

Mr. CHANDLER. Thank you very much, Mr. Chairman. I am delighted to hear your testimony.

As the members of the committee know, I am a cosponsor of this measure with my colleague from the State of Washington, Mr. Lowry.

One particular question: You mentioned amendments to narrow the scope of the legislation. Have you prepared those and submitted them? Do you have copies that you are suggesting for the committee?

Mr. STEUERLE. We do not have any at this time, Mr. Chandler. But we would be glad to work with the committee on this particular issue.

Mr. CHANDLER. Is it your opinion that, as worded, the bill would exempt from taxation any income to a tribal member?

Mr. STEUERLE. No, it is income just with respect to certain fishing rights. Our concern is partly with respect to litigation over a number of similar areas, which we think needs to be clarified.

A second issue, Mr. Chairman, which I think perhaps you would have particular concern with is the exemption from taxes, which we believe can be derived from the treaties, or an interpretation of the spirit of those treaties, which would also apply to Social Security taxes.

And we have some concern as to whether all Indian groups, for instance, would want to be exempted from those Social Security taxes.

As you know, Social Security is basically a redistributive scheme. If the Indians involved were low income individuals, we would pay very little income tax. It is not clear that exemption from Social Security tax would actually be to their benefit. That is, they would probably lose more in present value of future Social Security benefits than they would gain in terms of exemption from Social Security taxes.

So there are a number of these issues with which we would like to work with you and the committee over time.

Mr. CHANDLER. Mr. Chairman, I think that is an excellent suggestion, and the spirit of it is well taken.

I would urge the committee to meet with representatives of the tribes in our State and elsewhere to deal with that. Certainly, their wishes, I think, ought to be a primary driving force.

Mr. STEUERLE. Just as a caution there, Mr. Chandler, if the theory is that the income is not taxable because of the treaties, it is not clear that one can necessarily exempt it from income tax but not Social Security tax. Maybe you have to either exempt them from both or neither. It is not clear, again, if they are low-income individuals, that the income tax penalty is that great; that the Social Security benefits would not be greater than the loss.

And again, we would like to work with you on this issue.

Mr. CHANDLER. All right. Well, I think that pretty well clarifies it. It is the administration's view that this legislation ought to pass, Mr. Chairman. The main purpose in my being here this morning was to establish that.

Thank you for the opportunity.

Chairman RANGEL. Well, we are pleased to hear the administration's support on this important issue.

Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman. Just a few quick questions on behalf of the committee.

What is your opinion about whether or not it is good policy to exclude the families of Indian fishermen from survivors' benefits?

Mr. STEUERLE. Well, Mr. Andrews, again, this is what I just spoke to Mr. Chandler about. I think we would want to work with the Indian tribes to see whether they wanted to be exempted from survivors' benefits or the Social Security benefits.

The difficulty here is that if the spirit of the treaty is that they can be exempt from tax, we believe that we should honor the spirit of that treaty. However, whether in the end it is to the ultimate benefit of all the tribes is another question. That is the reason we would want to work with them. They may decide that even if it is within the spirit of the treaty, that other considerations override.

Mr. ANDREWS. For instance, let me ask you, would low income Indian fishermen and their families be worse off if they lost the earned tax credit?

Mr. STEUERLE. We believe that is possible. And again, it is something we would like to discuss with them.

Mr. ANDREWS. How should the income from an Indian-owned corporate fish processing plant be treated, if not all the fish processed are caught in tribal waters?

Mr. STEUERLE. I understand, Mr. Andrews.

Indeed, one of the other issues that we would want to work on again in drafting is the question of how one allocates income, were income derived by either a corporation, a partnership, or an individual, including both taxable and nontaxable sources.

We would want to ensure that the income was allocated properly and taxed according to income tax and Social Security tax principles.

Mr. ANDREWS. How should the income of an Indian crew member on a non-Indian boat be treated if fish are caught in waters where Indians have fishing rights but not exclusive rights?

We are getting into harder questions now.

Mr. STEUERLE. This is a matter of case law, Mr. Andrews, and we have supported that exemption. But there is case law on this.

Mr. ANDREWS. Thank you, Mr. Chairman.

Chairman RANGEL. I assume in the case of the Indians, that you are concerned about their long-term security, rather than any short term windfall?

Mr. STEUERLE. That is correct, Mr. Rangel.

Chairman RANGEL. Now, we would like to hear your views on the taxing of the housing benefits of our people at the United Nations.

Mr. STEUERLE. The proposal being considered on housing allowances of the U.S. mission to the United Nations would amend section 912(1) of the code in order to exclude from gross income of employees of the U.S. Government housing benefits provided under section 8 and 9 of the United Nations Participation Act.

The Treasury Department has concerns about this proposal. The eligibility for exclusions under section 912, including any exclusion for housing allowances, has historically been limited to Government officials and employees stationed outside the continental United States. The rationale for this limitation is that section 912 is designed to provide benefits to Government employees compara-

ble to those provided to private sector employees under section 911 of the code. Under this latter section, only housing allowances for foreign housing are excludable from gross income, based on the theory that such tax-free allowances encourage employment of Americans abroad, who will promote U.S. exports.

If the section 912(1) exclusion were extended to Government employees stationed at the U.S. mission to the United Nations in New York, it would no doubt soon be argued that the exclusion should be extended to other Government employees in New York. And since the exclusions under sections 912 or 911 are designed to be roughly comparable, some might plausibly argue for exclusion for housing benefits provided to private sector employees living in New York, something perhaps you would dislike, Mr. Chairman.

We recognize that the high cost of housing in New York creates difficulties for the State Department in recruiting talented individuals to serve in the U.S. mission to the United Nations.

Moreover, we especially appreciate the problems that the State Department personnel face with regard to potential tax liabilities resulting from the receipt of these housing allowances in past years, allowances the employees were told were tax free.

In any case, we have committed to work with the State Department, the Office of Management and Budget, and the Office of Personnel Management, to derive an overall compensation package for employees assigned to the United Nations that would address these legitimate concerns within a framework of sound tax policy and evenhanded treatment of all taxpayers under the law.

Chairman RANGEL. Don't want it. Even had to trim it. What are you going to work out with them?

Mr. STEUERLE. Mr. Chairman, again we have some concern with respect to employees who, in the past, were told these benefits were tax-free, and have arranged their affairs on these matters. One way that we might be able to work out some sort of agreement is to examine the overall compensation package, including the way the State Department compensates individuals directly.

Chairman RANGEL. You are not going to examine the overall compensation package of State Department employees, are you?

Mr. STEUERLE. No, Mr. Chairman. We are committed to work with the State Department, the Office of Management and Budget, and the Office of Personnel Management. We will have input on the tax issues.

Chairman RANGEL. Mr. Secretary, they are in absolute panic that IRS is going after what they consider to be a fringe benefit, and interpret it as income.

Whatever help you can get from your associate, who will identify himself for the record, we would appreciate it. It would be appreciated by the committee.

Our ambassador to the United Nations is very concerned about this, and we are holding hearings because, I think, they have found legislative relief for this problem in the Foreign Affairs Committee. So, I would want to know what do you think you can work out without legislation.

Mr. STEUERLE. Mr. Chairman, we believe that, if we examine this issue with these other agencies, we may be able to find a compensation package which does not require changing the tax laws. Our

concern is that, if you exempt U.N. employees who work in New York, then you have a case for exempting people who work at the Department of Agriculture or other agencies who happen to live in New York.

You also have the question of why we should not exempt State Department personnel who happen to live in the city of Washington, should its costs rise. We have the question of why we want to necessarily favor these employees over other employees, say, of business firms that work in the State of New York. So, we have real concern with trying to solve this through the Tax Code.

We are committed to providing advice on what can be done with respect to the Tax Code. There are a couple of exceptions that might be used with respect to the treatment of employee expenses on temporary duty stations and certain costs of working, and we will try to see whether these exemptions might be applied, especially to future personnel that may be stationed in New York, depending on their tour of duty and other things.

Would you like to add to that?

Chairman RANGEL. Is anyone here that is talking with the State Department about this specific problem as it relates to present tax liability of United Nations staff stationed in New York?

Mr. EVANS. Mr. Rangel, my name is Thomas Evans. We are working in consultation with the IRS to meet with the State Department to address these issues and to see what can be done about this problem. That has not yet been done, but we have been instructed to do so in the near future.

Chairman RANGEL. Is forgiveness included in this discussion for past tax liability for what they thought was a fringe benefit as opposed to income?

Mr. EVANS. Well, sir, in terms of the IRS doing something administratively, it might be difficult to do that with the present statutory framework. Nevertheless, the IRS may be able to advise these people, for example, as to whether their housing allowances met other requirements under the code for favorable tax treatment such as section 119 regarding housing for the convenience of the employer, and section 162 for expenses incurred while you are traveling and away from home. The IRS will be able to look at the situation and advise State as to the tax consequences of transactions that have already occurred.

Chairman RANGEL. Are you directly involved in these discussions?

Mr. EVANS. Yes, I am.

Chairman RANGEL. Have you been in touch with Ambassador Walters on this?

Mr. EVANS. Deputy Secretary McPherson has discussed this issue with Ambassador Walters. I have not personally done so, sir.

Mr. STEUERLE. We have worked with the Office of Management and Budget, which has agreed to coordinate these efforts, and believes that enactment of this bill at this time would also be premature. They are, by the way, at the same time examining the overall question of housing allowances and how they might be designed and treated. So, they simply believe that overall—

Chairman RANGEL. Is there legislation on this issue?

[Discussion off the record.]

Chairman RANGEL. I understand that the legislation which I think we were holding these hearings on has been dropped from the State Department appropriations. I think State wanted to correct this matter. They may be relying on these negotiations, so that the committee may have to get back in touch with you, subject to the direction we receive from our chairman as well as the chairman of the Foreign Affairs Committee.

Mr. STEUERLE. As you are aware, Mr. Chairman, too, another difficulty is that in the reconciliation process we agreed not to have revenue losers in the bill. And even though this may be a very small revenue loss, that is another reason why it would be difficult to include this in any reconciliation bill.

Chairman RANGEL. Well, the improvement in the quality of staff at the United Nations might improve our economic situation in terms of the balance of trade, which, of course, in the long run might raise revenue. We look at this as a revenue raiser. [Laughter.]

Are there any other questions for the Secretary and his assistant on this or any other issues?

[No response.]

Chairman RANGEL. We thank you, and I assume you would agree to study the testimony of the consumer advocates as it relates to the utility question.

Mr. STEUERLE. Certainly, Mr. Chairman. Thank you.

Chairman RANGEL. We have a panel here, headed by the distinguished attorney general of New York, who has been advocating changes in existing laws as they relate to utilities. Prior to becoming the attorney general, he served in the New York State Senate, and I had the honor and privilege to serve with him in the New York State Assembly.

That is the Honorable Robert Abrams, our attorney general, heading this panel.

He will be accompanied by the commissioner from the North Dakota Public Service Commission. I will ask Mr. Dorgan to introduce that witness for us.

Mr. DORGAN. Mr. Chairman, Bruce Hagen from North Dakota is with us today. And Bruce is president of the National Association of Regulatory Utility Commissioners. Bruce has been a commissioner in North Dakota for many years, since the 1960s. He does an outstanding job, and we are very pleased that he is able to be with us at the committee this morning.

Chairman RANGEL. I see Mr. Coyne has a representative from the Commonwealth of Pennsylvania here. I will ask him to introduce him.

Mr. COYNE. Yes, Mr. Chairman. I'd like to extend my welcome to David M. Barasch, who is the consumer advocate for the Commonwealth of Pennsylvania.

Chairman RANGEL. Mr. Hagen, will you identify yourself?

We have a 5-minute rule. So, if there is no objection from the committee, your prepared statements would be entered into the record, and you could proceed in a manner in which you feel comfortable.

The Chair yields now to Mr. McGrath.

Mr. McGRATH. Mr. Chairman, I would like also to welcome Attorney General Abrams to our panel, and to note for the record that his in-laws live in my district.

Chairman RANGEL. Can't win 'em all. [Laughter.]
Mr. Attorney General.

STATEMENT OF ROBERT ABRAMS, ATTORNEY GENERAL, STATE OF NEW YORK

Mr. ABRAMS. Thank you very much, Mr. Chairman, and members of this committee. Allow me at the outset to thank you for this opportunity to testify in support of H.R. 1049.

This bill would facilitate the timely return of billions of dollars in utility overcharges to millions of ratepayers across the country. The issue before this subcommittee is whether utilities will be allowed to arbitrarily delay compensating their ratepayers for \$19 billion in excess charges, funds which they have collected in anticipation of Federal income taxes which the utilities do not and will not owe.

Utility companies acknowledge that they have overcollected for Federal income taxes. The only issue is whether their ratepayers will be compensated for these overcharges within a fair and reasonable period of time.

Now, how did this situation come about? There are two basic causes of these overcharges. One due to a long-standing loophole in the Internal Revenue Code, and one due to a recent change in corporate income tax rates.

First, the Internal Revenue Code permits utility companies to use two sets of books. One for paying its Federal income taxes, and another for justifying its requests for rate increases. This provision allows utilities to claim a certain level of Federal income taxes for ratemaking purposes, but to pay only a fraction of that amount immediately. The difference between the amount collected and the amount paid out is called deferred Federal income tax.

In fact, utilities may use these funds however they see fit. They function as a sort of unacknowledged loan from the ratepayers to the utility companies. Thanks to this loophole, utilities charge their ratepayers for Federal income taxes which they may not have to pay for many years to come, if ever.

Reduction of the top corporate Federal income tax rate, from 46 to 34 percent in the Tax Reform Act of 1986, has put a very large pool of excess charges into the coffers of utility companies. Utilities were collecting deferred taxes on the assumption that they would some day have to pay them at the higher 46-percent rate. Now that they have lower taxes, the utilities have no legitimate claim to the difference between what they now owe the Internal Revenue Service and the amount collected to pay the former higher tax rate.

These excess deferred Federal income taxes accounted for 26 percent of the total deferred taxes held by the utilities at the end of 1986. As a representative of the consumers and ratepayers of New York State, I am particularly concerned that this inequitable situation be rectified.

As of the end of 1986, New York's 12 largest electric, gas, and telephone utilities had collected \$4.5 billion in deferred Federal

income taxes. The reduction in the top corporate tax rate means that New York utilities now hold at least \$1.2 billion that should be returned to New York ratepayers.

Without a change in the Federal tax laws, ratepayers in New York and across the Nation may have to wait as long as 45 years to be compensated for the money that they have been overcharged. This intolerable delay results from the provision of current law which allows utilities to return excess tax collections over the time it takes them to depreciate their assets.

Not only is this delay grossly unfair to ratepayers, it is also bad economic policy. From a business viewpoint, tying the return of tax overcharges to asset depreciation makes no sense. The return schedule should bear some relationship to the financial condition and other unique circumstances of each utility.

For some utilities, delaying the return may produce a financial windfall. For others, which may be suffering severe financial or operating difficulties, a different return schedule may well be in order. Despite these significant differences among utilities, the current law takes into account only a utility's depreciation schedule and the amount of excess deferred taxes that it owes ratepayers.

Let me describe for you the situation among the major utilities in my own State by way of illustration. Two of the financially soundest utilities in New York, New York Telephone and Con Ed, control nearly two-thirds of the tax overcharges owed to New York taxpayers. At least in my State, the utilities which are least in need of financing are deriving the greatest benefit from the current system.

Some of those who oppose timely return of tax overcharges to ratepayers argue that utilities do not have the cash available to compensate ratepayers. But this is not true for all utilities. For example, both New York Tel and Con Ed have demonstrated that they have more than enough cash to cover their operating and construction costs.

In 1986, Con Ed transferred \$253 million to unregulated subsidiaries, and repurchased more than \$106 million of its own stock. These outlays are more than twice the amount that Con Ed owes its ratepayers for tax overcharges.

In 1986, New York Telephone reduced its total long-term and intermediate debt by almost \$200 million, an amount that it could have used to compensate ratepayers for tax overcharges. Other utilities may end up having to borrow in order to make more timely compensation to ratepayers who have been overcharged. Even if this were done and incorporated into higher rates, consumers would still see a net gain due to the differential between interest rates utilities can borrow at compared with individuals.

In any case, I am not suggesting that every utility immediately send out checks to every ratepayer for these overcharges. The point is that the rate at which compensation will be made should be determined by the financial circumstances of each utility, and not by the rigid formula which controls today.

So, what's needed is an approach which balances the utility's ability to make refunds, whether in the form of reductions in rates, direct refunds, or other means, against the amount that it owes its ratepayers. This balancing is what State utility regulators do,

based on their intimate knowledge of the financial position and unique circumstances of each utility in their State.

The Tax Reform Act of 1986 has imposed an inflexible mechanistic approach which ignores the actual needs of consumers and utilities. And so, Mr. Chairman, I urge Congress to repeal section 203(e) of the Tax Reform Act, so that utility regulators in New York and other States will have the flexibility that they need to return excess deferred Federal income taxes to ratepayers in ways that are fair to both ratepayers and utilities.

A longer statement I will submit to the committee for the record.

Chairman RANGEL. Without objection.

[The prepared statement follows:]

STATEMENT OF ATTORNEY GENERAL ROBERT ABRAMS
IN SUPPORT OF H.R. 1049
SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE COMMITTEE ON WAYS AND MEANS
DECEMBER 14, 1987

Mr. Chairman, Representative Vander Jagt, and members of the Subcommittee. Thank you for this opportunity to testify in support of H.R. 1049; which would permit the timely return of billions of dollars in excess utility charges to ratepayers.

The issue before the Subcommittee is whether utilities will be allowed to arbitrarily delay returning to ratepayers \$19 billion in tax overcharges. These are funds that utilities have collected to pay federal income taxes that the utilities do not, in fact, owe. Utilities do not deny that they have overcollected for federal income tax charges. The only issue is whether ratepayers will be compensated for these overcollections within a reasonable time.

The utilities collected the excess federal income tax charges through an Internal Revenue Code loophole that permits them to use two sets of books, one for paying federal income taxes and the other for asking for rate increases. The Code allows utilities to claim a certain amount of federal income tax expense for ratemaking purposes, but to actually pay only a fraction of that amount immediately. Utilities account for the difference on their books as "deferred federal income tax" but use the cash in any way they wish.

Thanks to this loophole, utilities charge ratepayers for federal income taxes that will not have to be paid for many years, if at all. By the end of 1986, electric, telephone and natural gas pipeline utilities alone collected \$73 billion in deferred federal income taxes, while natural gas distributors, water companies and other regulated utilities collected additional millions.

Utilities now have excess deferred federal income taxes because the Tax Reform Act of 1986 cut the maximum corporate federal income tax rate from 46% to 34%, effective July 1, 1987. Utilities collected the deferred taxes on the assumption that they would some day pay them at the higher 46% rate. Now that their taxes are lower, the utilities have no claim to the difference between what they now owe the Internal Revenue Service and the amount collected to pay the former tax rate. These "excess deferred federal income taxes" are 26% of the total deferred federal income taxes collected through the end of 1986. Since January 1, 1987, the amount of additional excess deferred federal income tax accumulated has varied from utility to utility, depending on such factors as regulatory action and accounting assumptions used.

As of the end of 1986, New York's dozen largest electric, gas and telephone utilities had collected \$4.5 billion in deferred federal income taxes. The reduction in the maximum corporate federal income tax rate means that New York utilities now hold at least \$1.2 billion that should be returned to New York ratepayers.

The amounts of each utility's deferred federal income taxes and excess deferred federal income taxes, however, are not related to the individual utility's need for financing. I have prepared a chart of the dozen largest New York electric, gas and telephone utilities to illustrate this lack of relationship between their financial conditions and the the varying amounts of deferred taxes and excess deferred taxes each holds:

<u>Utility</u>	<u>Total Accumulated Deferred Federal Income Taxes (millions)*</u>	<u>Excess Deferred Federal Income Taxes Owed Ratepayers (millions)*</u>	<u>Standard & Poor's Bond Rating**</u>
New York Telephone	\$2,250.8	\$587.2	AA+
Consolidated Edison	623.4	162.6	AA
Long Island Lighting	621.4	162.1	BB-
Niagara Mohawk Power	409.4	106.8	BBB
New York State Electric & Gas	213.5	55.7	BBB
Rochester Gas & Electric	73.7	19.2	BBB+
Brooklyn Union Gas	66.4	17.3	A+
Orange & Rockland Utilities	59.2	15.4	AA
Central Hudson Gas & Electric	42.3	11.0	BBB+
Continental Telephone	38.4	10.0	A-
Rochester Telephone	35.6	9.3	AAA
National Fuel Gas	17.4	4.5	A
TOTAL	\$4,451.5	\$1,161.1	

* As of December 31, 1986. Sources: U.S. Federal Regulatory Commission (FERC Form 1); U.S. Federal Communications Commission (FCC Form M); U.S. Energy Information Administration.

** As of December 7, 1987

It is immediately obvious from an inspection of this chart that almost two-thirds of the excess deferred federal income taxes owed to New York ratepayers are held by the two utilities best able to make refunds. New York Telephone and Consolidated Edison between them owe ratepayers \$749.8 million, which is 65% of all the excess deferred taxes held by major New York utilities. In New York, at least, current federal tax law primarily benefits those utilities that least need it.

While New York utilities now owe their ratepayers a billion dollars, ratepayers may have to wait as long as 45 years for compensation unless Congress changes the federal tax laws. Current law permits utilities to return excess deferred taxes over the time it takes them to depreciate their assets. For some assets, depreciation may take as long as 45 years.

This delay is unfair to ratepayers. It is also bad economic policy. Tying return of excess collections to depreciation is unfair because it hinders returning the excess to the people who paid it. The longer it takes to return the excess, the more likely it is that the ratepayers who paid the charge will move out of a utility's service territory, die or otherwise not receive the compensation due them.

Tying the return of excess deferred federal income taxes to asset depreciation is bad economic policy because the return schedule is not related, as it should be, to the financial condition or other circumstances of each particular utility. This means that the speed of return of excess tax collected under current law disregards entirely the best interests of ratepayers and utilities. For some utilities, delaying the return may produce windfall profits. Other utilities may be in severe financial difficulties. Despite these wide differences, the current law takes into consideration only a utility's depreciation schedule and the amount of excess deferred taxes that it owes ratepayers.

New York has utilities at both extremes of the financial spectrum. New York Telephone and Consolidated Edison are both extremely profitable and have high financial ratings. The Long Island Lighting Company, on the other hand, is solvent only because consumers pay a \$400 million a year surcharge over and above what LILCO can justify from its cost of operation. Other New York utilities fall somewhere between these two extremes.

What is needed is a balancing of a utility's ability to make refunds against the amount owed its ratepayers. This balancing is what State utility regulators do, based on their intimate knowledge of the financial and other circumstances of each utility. Current federal tax law, however, prohibits the balancing of utility and ratepayer interests in the return of excess deferred taxes. Instead, the tax law applies a mechanistic formula that ignores the needs of both ratepayers and utilities.

The current rigid return formula compares unfavorably with the flexibility permitted the last time ratepayers were owed excess deferred federal income taxes. The Revenue Act of 1978 reduced the maximum corporate income tax rate from 48% to 46%. This change created excess deferred federal income taxes different only in amount from those resulting from the Tax Reform Act of 1986. In 1978, however, Congress placed no restrictions on the scheduling of compensation to consumers.

Some who oppose timely return of excess deferred federal income taxes argue that utilities do not have the cash to compensate ratepayers. This is not true for all utilities. New York Telephone and Consolidated Edison have more than sufficient cash to cover their operation and construction costs. For example, in 1986 Consolidated Edison transferred \$253.4 million to unregulated subsidiaries and repurchased \$106.4 million of its own stock. These outlays, totaling \$359.8 million, are more than twice what Consolidated Edison owes its ratepayers for excess deferred federal income taxes. In 1986 New York Telephone reduced its total long term and intermediate debt by \$199.5 million, which means that the company could have reduced its excess deferred federal income tax by a comparable amount.

In New York the utilities that owe ratepayers the most excess deferred federal income taxes have the cash to make refunds. Compensation, however, need not be in the form of a refund check. Compensation can come in the form of reductions in utility rates, retirement of outstanding deferred charges, accelerated depreciation of plant or through a variety of other methods.

Some utilities may have to borrow in order to make refunds to ratepayers. If a utility does have to borrow, the cost of borrowing may come out of utility profits rather than be passed through as higher rates. For example, a rate proceeding to implement the return may uncover utility cost savings greater than the cost of borrowing to pay back excess deferred federal income taxes. But even if the cost of borrowing to make compensation does increase utility rates, the net result to the average ratepayer will be a saving because the average ratepayer's cost of borrowing is considerably higher than a utility's.

The average consumer pays 18% for credit card debt, 15% for personal loans and 11% for mortgages. Utilities can borrow at far lower rates. For example, in 1986 New York Telephone borrowed \$900 million long term at rates no greater than 8.75%. Niagara Mohawk, a utility with a credit rating far lower than New York Telephone's, sold \$100 million worth of bonds in July 1987 at a cost of 9.6%. Even at the rates Niagara Mohawk pays for money, the average consumer benefits significantly if a utility borrows at 9.6% to return money to a consumer who otherwise would have to pay more.

My point is not that utilities should be forced to borrow to return money to ratepayers. What I am trying to get across is that even if a utility borrows in order to return excess deferred federal income taxes to its ratepayers, it may be to their benefit, depending on other factors such as a utility's cost of borrowing.

The bottom line is this: determining how best to compensate ratepayers for the excess federal income tax charges that they have paid utilities is a complex question highly dependent on the circumstances of each utility. Despite the complexities, the Tax Reform Act of 1986 provides a Procrustean answer that completely ignores the enormous variation between utilities. I therefore ask Congress to repeal §203(e) of the Tax Reform Act so that utility regulators in New York and other states will have the flexibility they need to return excess deferred federal income taxes to ratepayers in ways that are fair to both ratepayers and utilities.

Thank you.

Chairman RANGEL. Without objection. Mr. Hagen.

STATEMENT OF BRUCE HAGEN, PRESIDENT, NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS AND COMMISSIONER, NORTH DAKOTA PUBLIC SERVICE COMMISSION

Mr. HAGEN. Thank you, Mr. Chairman, and members of the subcommittee. We are grateful for this opportunity to testify on the merits of H.R. 1049.

This legislation has been a priority of our association since it was introduced this February. As this year's president of the National Association of Regulatory Utility Commissioners, or NARUC, I am here representing the governmental agencies of the 50 States, the District of Columbia, Puerto Rico, and the Virgin Islands engaged in the regulation of water, sewer, gas, electric, and telephone utilities.

With me is my distinguished colleague from New York, Peter Bradford, who happens to be last year's president of NARUC.

Our chief objective is to serve the public interest by seeking to improve the quality and effectiveness of regulation. I can tell you that excess deferred taxes have been on the minds of each of our 350 members this year as we have worked with the utilities we regulate to pass along to ratepayers some of the benefits of last year's Tax Reform Act.

It would be an understatement to say that it has frustrated many of us to know that billions upon billions of dollars of those benefits are beyond our grasp. According to data compiled by the NARUC and provided to the subcommittee, excess deferred taxes totalled at least \$19 billion nationwide at year end 1986, or roughly \$223 per American household.

I am not going to comment on the advantages or disadvantages to normalizing the refunds of excess deferred tax dollars at question here. Frankly, I think the relative merit of using one method or another will vary depending upon which company you look at.

For this reason, the treatment of utilities' excess deferred taxes is most logically made by those governmental officials charged with maintaining that ever-sought-after balance which keeps investor-owned utilities afloat with a fair rate of return on their investments and, at the same time, ensures that the rates they charge are fair and affordable for ratepayers.

Mr. Chairman, I represent those officials. We regulate the water, sewer, gas, electric, and telephone utilities which collected the now-excess deferred taxes through utility rates we authorized. Because excess deferred taxes, by definition, are funds which are never paid to the Federal Treasury, it is our feeling that the moment the corporate tax rate was reduced those excess dollars effectively became rate overcollections. Most investor-owned utilities in the country hold some and, to suggest that each one of them is equally deserving of the across-the-board treatment afforded to them by section 203(e) of the Tax Act, is to ignore voluminous data which prove otherwise.

I want to make clear that no one is blaming the utilities for having excess deferred taxes. They are an inevitable result of the tax rate reduction. What we are saying is now that they exist, utili-

ties should be required to justify to the relevant regulatory commission why it is they should be permitted to hold on to them. This is prudent regulatory practice.

If, for instance, in my State, North Dakota, a utility for some unforeseen reason has overcollected from its ratepayers, our commission has the obligation of determining the most appropriate refund or rate adjustment period for the overcollection. In a scenario similar to the case of excess deferred taxes, let's say the utility collected the funds in good faith through rates ordered by our commission and relied on the assumption it would be able to keep those funds. Under these circumstances, any responsible regulator would choose to return the extra funds to the ratepayers, to whom they belong, at a pace which takes into account the financial needs of the utility.

State regulators are uniquely qualified to make these kinds of decisions. In the course of setting utility rates, we have acquired an intimate knowledge of the financial condition of each of the companies we regulate. We know how much a utility has borrowed and how much cash it has on hand. We know what diversification ventures it has entered, and what its future plans for expansion are.

We know about the profits it has earned, the dividends it has issued, and the nature of the competition it faces. To me, regulatory commissions are the logical bodies to charge with handling the excess deferred tax windfall. The executive committee of the NARUC adopted a unanimous resolution this February, which unequivocally endorses this view and Congressman Dorgan's H.R. 1049.

Some have argued that State regulators are vulnerable to political pressure to refund excess deferred taxes quickly. This may be true, but I can think of no worse a political move for a commissioner to make than to put a utility it regulates out of business, or even to order refunds in one year and then be forced to order a rate increase the following year.

I run for election in North Dakota. What I said is what I really believe.

Contrary to the rhetoric of some, the facts indicate that immediate refunds would not result if regulatory commissions were to have discretion over excess deferred taxes. There was no restrictive language in the 1978 law reducing the maximum corporate tax rate from 48 to 46 percent. State public service commissions were free to refund excess deferred taxes held by the utilities they regulated as quickly or slowly as they felt was appropriate.

The result is shown on the chart, appendix C, prepared by the NARUC, which I would like inserted into the record of this hearing. The chart shows that only three States required the refunds to be flowed through in 1 year, four States show 2 years for the refund, and eight States spread the refunds over 3 years. Interesting to note is that 10 States decided that the refund to ratepayers of excess deferred taxes should be normalized, and 4 States decided not to refund the money at all.

Perhaps more than any other data we could provide the subcommittee, this shows how inappropriate it is to use one single method for refunding the \$19 billion at question. We are not looking to take this money away from utility companies if they need it. All

we seek from the utilities we regulate is an adequate justification provided in an open forum for why the balance of interest between stockholders and ratepayers is best served by allowing a prolonged refund of moneys ratepayers have a legitimate right to.

Thank you very much for your attention.

[The prepared statement follows:]

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON SELECT REVENUE MEASURES

TESTIMONY OF

COMMISSIONER BRUCE RAGEN
NORTH DAKOTA PUBLIC SERVICE COMMISSION

PRESIDENT
OF THE

NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS
1102 INTERSTATE COMMERCE COMMISSION BUILDING
CONSTITUTION AVENUE AND TWELFTH STREET, N.W.
POST OFFICE BOX 684, WASHINGTON, D.C. 20044
TELEPHONE (202) 898-2200

ON

H.R. 1049, THE UTILITY RATEPAYER REFUND ACT OF 1987

DECEMBER 14, 1987



NARUC PRESIDENT BRUCE HAGEN
SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE WAYS AND MEANS COMMITTEE
DECEMBER 14, 1987

Mr. Chairman and members of the Subcommittee:

My name is Bruce Hagen and I am a Commissioner on the North Dakota Public Service Commission and this year's President of the National Association of Regulatory Utility Commissioners, or NARUC. Next to me is my distinguished colleague from New York, Peter Bradford, who happens to be last year's President of the NARUC.

The NARUC is a quasi-governmental, non-profit organization founded in 1889. Within our membership are the governmental agencies of the fifty States, the District of Columbia, Puerto Rico and the Virgin Islands engaged in the regulation of water, sewer, gas, electric and telephone utilities. Our chief objective is to serve the public interest by seeking to improve the quality and effectiveness of regulation.

We are grateful for this opportunity to testify on the merits of H.R. 1049. This legislation has been a priority of our Association since it was introduced this February. I can tell you that excess deferred taxes have been on the mind of each of our 350 members this year as we have worked with the utilities we regulate to pass along to ratepayers some of the benefits of last year's Tax Reform Act. It would be an understatement to say that it has frustrated many of us to know that billions upon billions of dollars of those benefits are beyond our grasp. According to

data compiled by the NARUC and provided to the Subcommittee [Attachment A], excess deferred taxes totalled at least 19 billion dollars nationwide at year end 1986, or roughly 223 dollars per American household.

I am not going to comment on the advantages or disadvantages to normalizing the refunds of excess deferred tax dollars at question here. Frankly, I think the relative merit of using one method or another will vary depending on which company you look at. For this reason the treatment of utilities' excess deferred taxes is most logically made by those government officials charged with maintaining that ever-sought-after balance which keeps investor-owned utilities afloat with a fair rate of return on their investments and at the same time ensures that the rates they charge are fair and affordable for ratepayers.

Mr. Chairman, I represent those officials. We regulate the water, sewer, gas, electric and telephone utilities which collected the now-excess deferred taxes through utility rates we authorized.

Because excess deferred taxes, by definition, are funds which are never to be paid to the Federal Treasury, it is our feeling that the moment the corporate tax rate was reduced, those excess dollars effectively became rate overcollections. Most investor-owned utilities in the country hold some, and to suggest that every investor-owned utility in the country is equally deserving of the across-the-board treatment afforded to them by Section 203(e) of the Tax Act is to ignore voluminous data which

prove otherwise.

I want to make clear that no one is blaming the utilities for having excess deferred taxes; they are an inevitable result of the tax rate reduction. What we are saying is, now that they exist, utilities should be required to justify to the relevant regulatory commission why it is they should be permitted to hold on to them. This is prudent regulatory practice.

If, for instance, in my State, North Dakota, a utility, for some unforeseen reason, has overcollected from its ratepayers, our Commission has the obligation of determining the most appropriate refund (or rate adjustment) period for the overcollection. In a scenario similar to the case of excess deferred taxes, let's say the utility collected the funds in good faith through rates ordered by our commission and relied on the assumption it would be able to keep those funds. Under these circumstances, any responsible regulator would choose to return the extra funds to the ratepayers to whom they belonged at a pace which takes into account the financial needs of the utility.

State regulators are uniquely qualified to make these kinds of decisions. In the course of setting utility rates, we have acquired an intimate knowledge of the financial condition of each of the companies we regulate. We know how much a utility has borrowed and how much cash it has on hand; we know what diversification ventures it has entered and what its future plans for expansion are; we know about the profits it has earned, the dividends it has issued, and the nature of competition it faces.

It would be impossible to determine what equitable rates are without this knowledge. To me, regulatory commissions are the logical bodies to charge with handling the excess deferred tax windfall. To support my view, I have a unanimous resolution adopted by the Executive Committee of the NARUC this February which unequivocally endorses Congressman Dorgan's H.R. 1049 and any other efforts to repeal Section 203(e) of the 1986 Tax Reform Act. [Attachment B]

Some have argued that State regulators are vulnerable to political pressure to refund excess deferred taxes quickly. This may be true, but I can think of no worse a political move for a Commissioner to make than to put a utility it regulates out of business, or even to order refunds in one year and then be forced to order a rate increase the following year.

Contrary to the rhetoric of some, the facts indicate that immediate refunds would not result if regulatory commissions were to have discretion over excess deferred taxes. There was no restrictive language in the 1978 law reducing the maximum corporate tax rate from 48 to 46 percent. State public service commissions were free to refund excess deferred taxes held by the utilities they regulated as quickly or slowly as they felt was appropriate. The result is shown on this chart prepared by the NARUC which I would like inserted into the record of this hearing. [Attachment C]

The chart shows that only three States required the refunds to be flowed through in one year. Four States chose two years

for the refund, and eight States spread the refunds over 3 years. Interesting to note is that 10 States decided that the refund to ratepayers of excess deferred taxes should be normalized, and 4 States decided not to refund the money at all.

Perhaps more than any other data we could provide this Subcommittee, this shows how inappropriate it is to use one single method for refunding the 19 billion dollars at question. It ignores so many important distinctions between companies, and it ignores the needs of ratepayers. We are not looking to take this money away from utility companies if they need it, all we seek from the utilities we regulate is an adequate justification, provided in an open forum, for why the balance of interests between stockholders and ratepayers is best served by allowing a prolonged refund of monies ratepayers have a legitimate right to.

Thank you for your attention. I would be glad to entertain any questions.

APPENDIX

There are two recent Private Letter Rulings (PLRs) which have been issued by the Internal Revenue Service (IRS) this year which have a direct bearing on the issues before this Subcommittee. I will not go into the details of either case as they are fully described in the attached copies of the rulings. [Attachments D & E] However, I would like to offer a brief remark for the record regarding these rulings.

In PLR # 8730013 issued by the IRS on April 21, 1987, the issue before the service involved the deregulation of certain telecommunications public utility property. The IRS ruled that when public utility property becomes deregulated, the deferred tax reserves associated with that property must be removed from the utility's regulated books and accordingly may not be used to reduce the utility's cost of service. Therefore the excess deferred taxes owed to customers will never have to be repaid.

Similarly, in PLR # 8735011 issued by the IRS on May 26, 1987, the issue before the service involved the sale of property between two public utility companies. Here, the IRS ruled that no portion of the accumulated deferred investment tax credits (ADITCs) associated with the property may be flowed through to the customers of the seller. Thus ADITCs legally owed to customers will never be repaid.

The significance of these rulings has a direct bearing on the treatment of excess deferred taxes in that they shed a great deal of light on how the IRS views deferred taxes and accumulated

deferred investment tax credits which lawfully may be used to reduce cost of service. In both instances future rate reductions associated with Federal tax benefits will be denied to utility customers due to the deregulation or transfer of the property. Stated more directly, moneys legally owed to ratepayers will not be refunded--not now--not ever!

I urge the Subcommittee to study carefully the issues raised here and to work with us in our effort to reverse the current practices of the IRS. I would be delighted to have appropriate NARUC and State commission staff sit down with you and/or Subcommittee staff to more fully discuss these rulings and their implications for our nation's public utility ratepayers for it is clear that the IRS is promulgating by administrative fiat certain tax consequences never contemplated by Congress when it enacted the normalization rules.

[illegible]

SOURCE: U.S. Federal Energy Regulatory Commission (FERC Form 1)
Regulatory Utility Commissioners

Compiled by the National

ATTACHMENT A (Continued)

COMPANY	TELECOMMUNICATIONS INDUSTRY		TOTAL ACCU. DEFERRED INCOME TAXES	EXCESS DEF. TAXES OVER DEFERRED INCOME TAXES
	ACCUMULATED DEFERRED INCOME TAXES-ACC. DEF.	ACCUMULATED DEFERRED INCOME TAXES-OTHER		
Alacom, Inc.	\$96,081,967	(\$896,188)	\$97,878,798	\$95,532,017
AT&T Communications	\$2,795,354,121	\$189,892,329	\$2,985,246,450	\$2,985,246,450
Bell Telephone Co. of Pennsylvania	\$876,611,489	\$45,250,762	\$921,862,251	\$921,862,251
C & P of Maryland	\$488,950,180	\$20,887,581	\$509,837,761	\$509,837,761
C & P of Virginia	\$141,472,286	\$14,468,083	\$155,940,369	\$155,940,369
C & P of West Virginia	\$157,265,741	\$8,251,569	\$165,517,310	\$165,517,310
Carolina Telephone and Telegraph	\$113,774,087	(\$5,995,815)	\$107,778,272	\$107,778,272
Central Telephone Company of Florida	\$113,542,088	\$4,832,839	\$118,374,927	\$118,374,927
Central Telephone Co. Chicago Ill.	\$44,908,946	\$9,067,992	\$53,976,938	\$53,976,938
Central Telephone of Illinois	\$42,335,292	\$0	\$42,335,292	\$42,335,292
Central Telephone of Virginia	\$48,110,664	\$4,866,084	\$52,976,748	\$52,976,748
Chesapeake & Potomac Telephone Co.	\$42,085,520	\$11,472,588	\$53,558,108	\$53,558,108
Cincinnati Bell Telephone Co.	\$156,491,579	\$16,089,632	\$172,581,211	\$172,581,211
Comtel of Texas	\$36,844,795	\$2,168,084	\$38,012,879	\$38,012,879
Continental Telephone Co. of California	\$38,278,946	(\$869,084)	\$37,409,862	\$37,409,862
Continental Telephone Co. of Virginia	\$86,180,532	(\$2,905,091)	\$83,275,441	\$83,275,441
Continental Telephone of Illinois	\$29,560,370	\$0	\$29,560,370	\$29,560,370
Continental Telephone of New York	\$39,087,810	(\$669,862)	\$38,417,948	\$38,417,948
Diamond State Telephone Co.	\$64,861,531	\$3,208,564	\$68,070,095	\$68,070,095
General Telephone Co. of Florida	\$128,387,039	(\$326,749)	\$128,060,290	\$128,060,290
General Telephone Co. of Indiana	\$117,358,287	\$2,178,814	\$119,537,101	\$119,537,101
General Telephone Co. of Ohio	\$209,558,639	\$2,487,750	\$212,046,389	\$212,046,389
General Telephone Co. of the Northwest	\$256,736,905	\$7,777,381	\$264,514,286	\$264,514,286
General Telephone Co. of the South	\$386,475,283	\$2,314,169	\$388,789,452	\$388,789,452
General Telephone Co. of the Southwest	\$679,285,664	\$3,481,566	\$682,767,230	\$682,767,230
General Telephone of California	\$99,235,060	(\$2,742,416)	\$96,492,644	\$96,492,644
General Telephone of Illinois	\$89,571,427	\$0	\$89,571,427	\$89,571,427
General Telephone of Michigan	\$82,387,074	\$2,099,404	\$84,486,478	\$84,486,478
General Telephone of Pennsylvania	\$44,027,952	\$2,999,705	\$47,027,657	\$47,027,657
General Telephone of the Midwest	\$144,383,985	\$269,720	\$144,653,705	\$144,653,705
Hawaiian Telephone	\$759,480,817	(\$3,183,475)	\$756,297,342	\$756,297,342
Illinois Bell Telephone Co.	\$281,705,741	\$29,603,536	\$311,309,277	\$311,309,277
Indiana Bell Telephone Co.	\$25,832,996	\$1,280,467	\$27,113,463	\$27,113,463
Lincoln Telephone and Telegraph	\$751,931,216	\$19,485	\$751,950,701	\$751,950,701
Michigan Bell Telephone Co.	\$1,400,132,640	\$16,703,885	\$1,416,836,525	\$1,416,836,525
Montana State Telephone Co.	\$1,041,089	\$181,994,864	\$1,042,035,953	\$1,042,035,953
New England Telephone & Telegraph Co.	\$1,090,060,061	\$1,780,813	\$1,091,840,874	\$1,091,840,874
New Jersey Bell Telephone Co.	\$829,956,080	\$55,108,770	\$885,064,850	\$885,064,850
New York Telephone Co.	\$2,111,303,182	\$45,788,385	\$2,157,091,567	\$2,157,091,567
Northwestern Bell Telephone Co.	\$800,684,128	\$139,567,711	\$940,251,839	\$940,251,839
Ohio Bell Telephone Co.	\$881,181,199	\$30,751,562	\$911,932,761	\$911,932,761
Pacific Bell	\$5,371,545,134	\$60,900,986	\$5,432,446,120	\$5,432,446,120
Pacific Northwest Bell Telephone Co.	\$640,306,151	\$158,966,146	\$799,272,297	\$799,272,297
Rochester Telephone Corp.	\$35,090,413	\$28,695,970	\$63,786,383	\$63,786,383
South Central Bell Telephone Co.	\$1,644,638,151	\$460,764	\$1,645,108,915	\$1,645,108,915
Southern Bell Telephone & Telegraph Co.	\$1,996,795,461	\$47,499,448	\$2,044,294,909	\$2,044,294,909
Southern New England Telephone Co.	\$383,910,393	\$135,892,581	\$519,802,974	\$519,802,974
Southwestern Bell Telephone Co.	\$2,626,661,886	\$34,903,261	\$2,661,565,147	\$2,661,565,147
United Inter-Connect Telephone Co.	\$46,805,232	\$181,085,128	\$227,890,360	\$227,890,360
United Telephone of Florida	\$20,367,897	(\$1,671,456)	\$18,696,441	\$18,696,441
United Telephone of Indiana	\$29,515,948	\$4,891,889	\$34,407,837	\$34,407,837
United Telephone of Missouri	\$27,651,244	\$0	\$27,651,244	\$27,651,244
United Telephone of Ohio	\$52,466,488	\$12,016,284	\$64,482,772	\$64,482,772
United Telephone of Pennsylvania	\$300,071,584	\$664,433	\$300,736,017	\$300,736,017
Wisconsin Bell	\$29,383,563,576	\$8,768,531	\$29,392,332,107	\$29,392,332,107
TOTAL (1986)	\$29,383,563,576	\$1,362,381,875	\$30,745,945,451	\$30,745,945,451

SOURCE: U.S. FEDERAL COMMUNICATIONS COMMISSION
FOC FORM 4

Compiled by the National Association of Regulatory
Utility Commissioners

ATTACHMENT A (Continued)
NATURAL GAS PIPELINE COMPANIES

COMPANY	* ACCUMULATED * DEFERRED * INCOME * TAXES	EXCESS DEF. TAXES OWED TO RATEPAYERS
Algonquin Gas Transmission Co.	* \$20,326,972	\$5,302,688
ANR Pipeline Co.	* \$272,002,130	\$70,957,077
Columbia Gas Transmission Corp.	* \$464,391,402	\$121,145,583
Columbia Gulf Transmission Co.	* \$94,480,790	\$24,647,163
Consolidated Gas Transmission Corp.	* \$146,563,509	\$38,233,959
East Tennessee Natural Gas Co.	* \$6,303,000	\$1,644,783
Enserch Corporation	* \$77,919,106	\$20,326,723
Florida Gas Transmission Co.	* \$26,459,406	\$6,902,454
Great Lakes Gas Transmission Co.	* \$65,404,347	\$17,062,004
K-W Energy, Inc.	* \$47,639,705	\$12,427,749
Michigan Consolidated Gas Co.	* \$191,410,362	\$49,933,138
Midwestern Gas Transmission Co.	* \$9,115,736	\$2,378,018
Mississippi River Transmission Corp.	* \$39,465,000	\$10,295,211
Mountain Fuel Resources, Inc.	* \$37,127,605	\$9,685,462
National Fuel Gas Distribution Co.	* \$48,026,739	\$12,528,715
National Fuel Gas Supply Corp.	* \$11,288,946	\$2,944,942
Natural Gas Pipeline Co. of America	* \$194,077,712	\$50,628,968
Northern Border Pipeline Co.	* \$204,178,083	\$53,263,848
Northern Natural Gas (ENRON)	* \$354,572,257	\$92,497,111
Northwest Alaskan Pipeline Co.	* \$12,279,716	\$3,203,404
Northwest Pipeline Corp.	* \$237,996,927	\$62,086,155
Overthrust Pipeline Co.	* \$9,708,942	\$2,532,767
Panhandle Eastern Pipe Line Co.	* \$149,902,919	\$39,105,109
Sea Robin Pipeline Co.	* \$20,736,365	\$5,409,487
Southern Energy Co.	* \$26,733,000	\$6,973,826
Southern Natural Gas Co.	* \$185,246,000	\$48,325,043
Stingray Pipeline Co.	* \$37,016,932	\$9,656,591
Tenneco, Inc.	* \$314,981,970	\$82,169,210
Texas Eastern Transmission Co.	* \$329,922,800	\$86,066,817
Texas Gas Transmission Corp.	* \$81,896,268	\$21,364,244
Trailblazer Pipeline Co.	* \$41,048,681	\$10,708,352
Transcontinental Gas Pipeline Corp.	* \$491,274,712	\$128,158,621
Transwestern Pipeline Co.	* \$53,345,861	\$13,916,312
Trunkline Gas Co.	* \$196,635,733	\$51,301,496
Trunkline LNG Co.	* \$113,743,060	\$29,672,103
Union Light Heat & Power Co.	* \$16,972,825	\$4,427,693
United Gas Pipe Line Co.	* \$168,001,840	\$43,826,567
U-T Offshore System	* \$6,218,967	\$1,622,339
Williams Natural Gas Co.	* \$47,608,098	\$12,419,504
Williston Basin Interstate Pipeline	* \$42,378,252	\$11,055,196
Wyoming Interstate Co., Ltd.	* \$24,835,721	\$6,478,884
TOTAL 1986	\$4,919,260,396	\$1,283,285,321

Compiled by the National Association of Regulatory Utility Commissioners

ATTACHMENT B

Resolution Regarding the Refund of
Excess Deferred Taxes

WHEREAS, The Tax Reform Act of 1986 lowered the maximum corporate tax rate from 46 to 34 percent; and,

WHEREAS, A significant portion of the deferred Federal income taxes collected in advance through service charges to ratepayers and now held by public utilities are no longer due to the Federal Treasury; and,

WHEREAS, The funds, called excess deferred taxes, constitute an overcollection of service charges and should be reimbursed to ratepayers; and,

WHEREAS, Section 203(e) of the Tax Reform Act prescribes an amortization schedule for excess deferred taxes that extends over the entire remaining book lives of a utility's assets; and,

WHEREAS, The appropriate treatment of excess deferred taxes collected by public utilities has historically been subject to the discretion of the utility regulatory commissions; and,

WHEREAS, Utility regulatory commissions are in the best position to determine the appropriate ratemaking treatment of excess deferred taxes according to the individual needs of the utilities they regulate; now, therefore be it

RESOLVED, That the Executive Committee of the National Association of Regulatory Utility Commissioners (NARUC), assembled in its Winter Committee Meeting in Washington, D.C., supports H.R. 1049 and any other legislation to repeal Section 203(e) of the Tax Reform Act of 1986 in order to return to utility regulatory commissions the authority to prescribe the appropriate ratemaking treatment of excess deferred Federal income taxes.

Sponsored by the Committee on Communications
Adopted by the Executive Committee February 26, 1987

ATTACHMENT C

PRIOR REGULATORY TREATMENT OF EXCESS DEFERRED TAXES

NAME OF AGENCY	AMORITIZATION PERIOD
ALABAMA PSC	Remaining Life
ALASKA PUC	Remaining Life
ARIZONA CC	
ARKANSAS PSC	1 Year
CALIFORNIA PUC	10 Years
COLORADO PUC	1.5 Years
CONNECTICUT DPUC	
DELAWARE PSC	2 Years
D.C. PSC	Remaining Life
FLORIDA PSC	5 Years
GEORGIA PSC	
HAWAII PUC	Remaining Life
IDAHO PUC	10 Years
ILLINOIS CC	Remaining Life
INDIANA PSC	No Decision
IOWA UB	NW Bell-2 Years/Others-5 Years
KANSAS SCC	No Decision
KENTUCKY PSC	2 Years
LOUISIANA PSC	2 Years
MAINE PUC	2 Years
MARYLAND PSC	5 Years
MASSACHUSETTS DPU	Remaining Life
MICHIGAN PSC	No Refunds Permitted
MINNESOTA PUC	3 Years
MISSISSIPPI PSC	3-5 Years
MISSOURI PSC	No Refunds Permitted
MONTANA PSC	
NEVADA PSC	3 Years
NEW HAMPSHIRE PUC	
NEW JERSEY BPU	Elec-3 Years/Tel-4 Years
NEW MEXICO PSC	Remaining Life
NEW YORK PSC	5 Years (generally)
NORTH CAROLINA UC	
NORTH DAKOTA PSC	Remaining Life
OHIO PUC	Remaining Life
OKLAHOMA CC	
OREGON PUC	
PENNSYLVANIA PUC	5 Years (generally)
RHODE ISLAND PUC	No Refunds Permitted
SOUTH CAROLINA PSC	
SOUTH DAKOTA PUC	3 Years
TENNESSEE PSC	Remaining Life
TEXAS PUC	No Refunds Permitted
UTAH PSC	
VERMONT PSB	3 Years
VIRGINIA SCC	
WASHINGTON UTC	3 Years
WEST VIRGINIA PSC	1 Year
WISCONSIN PSC	3 Years
WYOMING PSC	1 Year

Source: National Association of Regulatory Utility
Commissioners (NARUC) -12-

ATTACHMENT D

Internal Revenue Service

Department of the Treasury

Index Numbers: 0046.07-02
0160.00-00

Washington, DC 20224

Person to Contact:

8730013

Telephone Number:

Refer Reply to:

CC:C:2:6 - TR-31-113088-85

Date: APR 21 1987

• LEGEND:

Taxpayer or Company:

State A
 State B
 State C
 State D
 State E
 State F
 State G
 State H
 State I
 State J

"This document may not be
 used or cited as prece-
 dent. Section 6110(j)(3)
 of the Internal Revenue
 Code."

Affiliates:

M

N

O

P

Q

District Director

000068

-2-

8730013 .

Dear :

This is in reply to your request for ruling dated November 21, 1985, as amended by submissions dated February 10, 1986, and letters dated April 16 and December 2, 1986, from your representatives, concerning the treatment of the deferred tax reserves and the accumulated deferred investment tax credits (ADITC's) attributable to assets that have been deregulated. You ask that we rule on the following questions:

1. Since certain public utility property must be removed from Affiliates' regulatory books of account as the result of deregulation legislation by States A through J, must the deferred tax reserves attributable to such property, accumulated pursuant to sections 167(l) and 168(e)(3) of the Internal Revenue Code, * be removed from such regulatory books, or may these reserves be used, directly or indirectly, to reduce rate base or cost of service (or be treated as no-cost capital)?
2. Similarly, may the ADITC's attributable to such property, accumulated pursuant to section 46(f) of the Code, be used, directly or indirectly, to reduce cost of service or rate base?

Taxpayer was incorporated in under the laws of State B and has its principal place of business at Taxpayer's affiliated group is engaged in furnishing exchange telecommunications and exchange access service in several states. The common stock of Taxpayer is widely held and publicly traded.

Taxpayer is the common parent of a group of affiliated corporations which file a consolidated federal income tax return under section 1501 of the Code. The books of account of Taxpayer and Affiliates are maintained on a calendar year basis, and their income is reported for federal income tax purposes under the accrual method.

Affiliates have been active in providing local communications exchange service, exchange access service, and intraLATA toll service, and continue to be subject to rate regulation at the federal and state level.

* Although all Code references are to the Internal Revenue Code of 1954, the principles of this ruling are also generally applicable to the normalization rules under the depreciation provisions added by the Tax Reform act of 1986.

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With respect to certain services provided by Affiliates M through Q, technological advances and increases in competition have made cost-related rate regulation inappropriate. Accordingly, as the result of either legislative or administrative action initiated in whole or in part by these Affiliates, cost-related methods of rate regulation of such services under the jurisdiction of a number of regulatory bodies will be terminated or are proposed to be terminated. The effect of these terminations on the deferred tax reserves and the ADITC's is the matter addressed in the above ruling request.

For example, in legislation enabling deregulation of all services except two-way switch voice grade circuits (i.e., normal telephone dial-up service) was enacted in State E. Among the services deregulated or permitted to be deregulated are one-way video, cellular services, radio-paging/mobile services, custom calling features, rotary lines, alarm services, two-point dedicated lines (no dialing necessary), high speed data transmission and special access services.

The proposals regarding deregulation vary in the number of affected services and the manner of implementation. In State D, for example, where legislation was enacted in allowing deregulation if an administrative determination can be made that a particular service is competitive, coin telephone service, and certain other special services have been deregulated; and consideration is now being given to deregulation of message telephone service. In States G and I, legislation permits deregulation to proceed on a service-by-service basis through administrative action.

The termination of a cost-related method of rate regulation for a particular service typically results in the removal of the cost of property used in providing the service from the regulatory rate base and of book depreciation with respect to such property from the calculation or determination of cost of service used in computing the permitted rates for regulated services. In situations where property is used jointly for regulated and deregulated services, a portion of the property is removed from the regulated rate base as well as the cost of service calculation.

In connection with the deregulation of a service, property related to the service which is removed from regulation may in some instances be transferred to a newly-created member of Taxpayer's group which will, in turn, carry on the newly-deregulated activity.

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In the regulatory period immediately preceding the removal from the regulatory books of the portion of an Affiliate's property used in a newly-deregulated service, such property will still be included in the computation of rate base or cost of service and classified as public utility property. The deferred tax reserves relating to such property will be subject to the normalization requirements of sections 167(1) and 168(e)(3) of the Code. Similarly, the ADITC's relating to such property will be subject to the limitations imposed by section 46(f).

After the deregulated property is removed from the Affiliate's regulatory books, the deferred tax reserves for depreciation and the ADITC's attributable to such property will not continue to be subject to such regulation.

Sections 46(f)(1) and (2) provide limitations on the treatment of the investment credit for ratemaking purposes and for purposes of the taxpayers regulated books of account. Under the provisions of 46(f)(1) the credit, in certain instances, may be used to reduce rate base provided that it is restored to the rate base not less rapidly than ratably. If an election is made under section 46(f)(2), the credit may be flowed-through to income but not more rapidly than ratably.

Section 46(f)(6) of the Code provides, in part, that for purposes of determining ratable flow through under section 46(f), the regulatory life used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulatory books of account shall be used.

Section 168(e)(3) of the Code expands the limitations of section 167(1) and provides a special rule for public utilities wishing to utilize the benefits of the Accelerated Cost Recovery System (ACRS) with respect to public utility property. Basically, it requires normalization by stating --

(A) IN GENERAL.--

The term "recovery property" does not include public utility property (within the meaning of section 167(1)(3)(A)) if the taxpayer does not use a normalization method of accounting.

(B) USE OF NORMALIZATION METHOD DEFINED.--

For purposes of subparagraph (A), in order to use a normalization method of accounting with respect to any public utility property--

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(1) the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes; and

(ii) if the amount allowable as a deduction under this section with respect to such property differs from the amount that would be allowable as a deduction under section 167 (determined without regard to section 167(1)) using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense under subparagraph (B)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such differences.

(C) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS, ETC.--

(1) IN GENERAL.-- One way in which the requirements of subparagraph (B) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of subparagraph (B).

(ii) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS.--

The procedure and adjustments which are to be treated as inconsistent for purposes of clause (i) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under subparagraph (B)(ii) unless such estimate or projection is also used, for ratemaking purposes, with respect to the other two such items and with respect to the rate base.

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Section 167(1)(3)(A) of the Code provides, in part, that the term "public utility property" means property used predominantly in the trade or business of the furnishing of telephone services, or other communication services if the rates for such furnishing have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

Section 167(1)(3)(G) of the Code provides, with minor exceptions, the same definition for the normalization method of accounting as found in section 168(e)(3)(B) above.

Section 1.167(1)-1(a)(1) of the Income Tax Regulations in describing the scope of section 167(1) of the Code states, in part, the following:

The normalization requirements of section 167(1) with respect to public utility property defined in section 1(3)(A) pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation under section 167 and the use of the straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account.

Under normalization accounting for ratemaking purposes the utility does not fully take into account the actual federal tax benefits in the year in which the utility receives the benefits. This is accomplished by allowing the utility to reduce its payable taxes at a rate different from that allowable for ratemaking purposes. Thus, the utility claims accelerated depreciation on its federal income tax return; however, on its regulated books of account the depreciation is claimed on a straight-line method of depreciation over the useful life used for regulatory purposes. Similarly, for federal income tax purposes the utility claims the full amount of the investment credit in the year the property is placed in service; however, the investment credit is flowed through to the ratepayers ratably over the regulatory life of the asset.

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The Service does not determine such purely regulatory questions as whether the proposals of a commission will produce just and equitable rates, nor does it discuss the relative merits of "stand-alone" or other methods of regulatory accounting. The Service in this ruling request will determine only whether the deferred tax reserves and the ADITC's with respect to the deregulated property should be removed from the regulatory books of account for purposes of the normalization rules when the respective property becomes deregulated.

The normalization requirements of section 168(e)(3) of the Code are similar to the normalization requirements in section 167(1) and interrelate with section 46(f). If a proposed method of accounting does not meet the normalization requirements of section 167(1) it will not meet the requirements of section 168(e)(3).

The normalization rules would be violated if the deferred tax reserves and the ADITC's were left on the utility's regulatory books of account and flowed through to the ratepayers after the property to which they relate becomes deregulated. The normalization rules contemplate that the ADITC's will be flowed through ratably over the regulatory life of the assets to which they relate, and the deferred tax incrementally over the regulatory life of the assets. Once property is deregulated it ceases to be public utility property as defined in section 167(1)(3)(A) of the Code. Said property is no longer depreciable for regulatory purposes and the tax reserves should be removed from the regulatory books of account. If the deferred tax reserves relating to property that was no longer regulated were to remain on the regulated books of account it would result in a procedure that is considered inconsistent under section 168(e)(3)(C) and therefore would not meet the normalization requirements of sections 167(1) and 168(e)(3)(B). Similarly, if the ADITC's relating to property that was deregulated were to remain on the regulatory books of account it would result in a violation of the requirements of section 46(f). If tax credits were accounted for under the provisions of section 46(f)(1) the rate base would be reduced by an amount larger than credits related to the assets included in rate base and upon which the depreciation expense was based. If the credits were accounted for under the provisions of section 46(f)(2), the amount used to reduce cost of service would include amounts attributable to assets that were no longer included in the rate base, therefore, the credits would be flowed-through to income more rapidly than ratably.

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Therefore, based on the above represented facts and our legal analysis, we rule that:

1. Where, as the result of deregulation legislation in States A through J, public utility property is removed from Affiliates' regulatory books of account, the deferred tax reserve attributable to such property must also be removed from the regulatory books, and no final regulatory order may be used, directly or indirectly, to reduce Affiliates' rate base or cost of service (or treat it as no cost capital).
2. Where, as the result of deregulation legislation in States A through J, public utility property is removed from Affiliates' regulatory books of account, the balance of the ADITC's accumulated under the provisions of section 46(f) of the Code attributable to such property must also be removed from the regulatory books, and no final regulatory authority order may be used, directly or indirectly, to reduce the Affiliates' cost of service or rate base.

No attempt is made in this ruling to address any situations other than those involving the requirements of a regulatory authority in connection with the removal of property with or without the removal of services from cost-related rate regulation.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by adoption of temporary or final regulations, to the extent the regulations are inconsistent with any conclusions in the ruling. See section 16.04 of Rev. Proc. 87-1 I.R.B. 7, 17. However, when the criteria in section 16.05 of Rev. Proc. 87-1 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

A copy of this ruling letter should be filed with the income tax return for the taxable year or years in which the transaction covered by this ruling is consummated.

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Pursuant to the power of attorney on file with this request,
a copy of this ruling is being sent to your designated
representative.

Sincerely yours,



Anthony Manzanares
Acting Director, Corporation
Tax Division

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ATTACHMENT E

Internal Revenue Service

Department of the Treasury

Index Number: 0046.07-02

Washington, DC 20224

Person to Contact:

Telephone Number:

8735011

Refer Reply to:

CC: C:2:6 - TR-31-32322-86

Date: MAY 26 1987

Legend:

Taxpayer or Buyer -

Seller -

Division M or
Selling Division -

State A -

District Director -

"This document may not be
used or cited as prece-
dent. Section 6110(j)(3)
of the Internal Revenue
Code."

Dear

This is in reply to your request for ruling dated June 16,
1986, wherein you ask:

1. In a taxable sale of public utility property from one regulated utility to another unaffiliated regulated utility in which the assets retain their public utility property status after the transaction, do the unamortized and unrecaptured accumulated deferred investment tax credits (ADITC's), related to that property, follow the assets or stay with the Seller?
2. Will the Taxpayer violate the normalization requirements of Section 46(f) of the Internal Revenue Code if Taxpayer's rate base or cost of service is reduced for the amortization of investment tax credits (ITC's) generated by the Seller, not transferred to the Taxpayer, and not subject to recapture at the time of the sale?

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Taxpayer is a public utility company that supplies electric and gas utility service through its operating divisions. On , Taxpayer completed the acquisition of substantially all of the assets and business of Division M of Seller. M, a regulated public utility company provided retail and wholesale natural gas services and operated a pipeline system in several states. This acquisition furthered Taxpayer's goal of expansion of its existing and related businesses.

At the time of the acquisition Seller had recorded on its books ADITC's totalling , as the result of investment in public utility property in State A. After the sale, section 47 of the Code required the recapture of of these credits, since the property was disposed of before the close of the useful life (lives) provided by this section. The treatment of the remaining balance of in the Seller's ADITC account is the subject of this ruling request.

At the time the Regulatory Commission of State A (Commission) approved the sale of the assets and business of Division M, the subsequent regulatory treatment of the ADITC was discussed. As a condition of the approval to the purchase, Commission required Taxpayer to request a ruling from the Internal Revenue Service as to the proper regulatory and tax treatment of the remaining balance in the ADITC account under the provisions of section 46(f) of the Code.

Section 105 of the Revenue Act of 1971 (Pub. L. No. 92-178, section 105, 1972-1 C.B. 443, 446) enacted section 46(e), [now section 46(f)], of the Code, which limited the authority of regulatory agencies to "flow through" to ratepayers the benefits of the ITC's.

Section 46(f)(1) of the Code limits the authority of regulatory agencies to "flow-through" to ratepayers the benefits of the ITC. It provides that no credit will be allowed on public utility property if:

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- (a) The taxpayer's cost of service for ratemaking purposes is reduced by reason of any portion of the credit allowable by section 38; or
- (b) The base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit, unless the reduction in rate base is restored ratably or faster.

Section 46(f)(2) of the Code provides a special election wherein a taxpayer may ratably flow through the credits to the cost of service. However, a taxpayer will be considered to be in violation of section 46(f) if:

- (a) The taxpayer's cost of service for rate-making purposes or in its regulated books of account is reduced by more than a ratable portion of the credit allowable by section 38 (determined without regard to this subsection), or
- (b) The base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

Section 46(f)(5) of the Code defines the term "public utility property" as follows:

- (a) Property which is public utility property within the meaning of subsection (c)(3)(B), and
- (b) Property used predominantly in the trade or business of the furnishing or sale of (i) steam through a local distribution system or (ii) the transportation of gas or steam by pipeline, if

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the rates for such furnishing or sale are established or approved by a governmental unit, agency, instrumentality, or commission described in subsection (c)(3)(B).

Buyer made a timely election to treat all of its assets under the provisions of section 46(f)(2) of the Code and, therefore, to ratably flow through the credits to the cost of service.

Section 46(f)(6) of the Code defines the term "ratable portion" as the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account.

Section 1.46-6(g)(2) of the Income Tax Regulations further clarifies what is considered "ratable" for purposes of section 46(f) of the Code by providing that what is "ratable" is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. A method of restoration, or reducing, is ratable if the amount to be restored to rate base, or to reduce cost of service (as the case may be), is allocated ratably in proportion to the regulated life of the property. Thus, for example, assume that the regulated depreciation expense is computed under the straight line method by applying a composite annual percentage rate to "original cost" (as defined for purposes of computing regulated depreciation expense). If, with respect to an item of section 46(f) property, the amount to be restored annually to rate base is computed by applying a composite annual percentage rate to the amount by which the rate base was reduced, then the restoration is ratable. Similarly, if cost of service is reduced annually by an amount computed by applying a composite annual rate to the amount of the credit, cost of service is reduced ratably by a ratable portion. If such composite annual percentage rate were revised for purposes of computing regulated depreciation expense beginning with a particular accounting period, the computation of ratable restoration or ratable portion (as the case may be) must also be revised beginning with such period. A composite annual percentage rate is determined solely by reference to the period of time actually used by the

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taxpayer in computing its regulated depreciation expense without reduction for salvage or other items such as over and under accruals.

If the ADITC remains on the Seller's regulated books of account and are ratably restored to rate base after the property to which the ITC's relate are transferred, a violation of the normalization rules under section 46(f) of the Code will occur. A ratable restoration would be an addition to rate base for assets that seller no longer owns. The Seller is no longer entitled to claim depreciation with respect to the property; consequently, there is no prescribed method for determining a ratable flow-through of the ITC to rate base that would satisfy the normalization rules. Because the remaining ADITC's do not relate to regulated utility property owned by the Seller, the Seller cannot pass the credits through to its customers.

This case involves a taxable sale of assets and the business of one utility to another utility and must be distinguished from a nonrecognition situation wherein the exchange is not recognized as a taxable transaction. In a taxable exchange, the transferee (purchaser) receives the benefit of a new basis in the property and, for the years prior to the repeal of the ITC, qualifies for the ITC for used property. It is the tax benefits associated with this new basis that flow-through to the Buyer's customers. If the Seller's accumulated ITC's were also flowed-through to the Buyer's customers, they would receive the benefit of two ITC's for the same property. Therefore, we conclude that the Seller's ADITC's should not follow the property and be flowed-through to the Buyer's customers.

In this case, the ADITC's should be removed from the regulated books of account and not be added to the Buyer's reserve for deferred ITC.

Based on the above represented facts and our legal analysis, we rule that:

1. In a taxable sale of property from one regulated utility to another unaffiliated regulated utility

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in which the assets retain their public utility status, the unamortized and unrecaptured ADITC's related to that property do not follow the assets but stay with the Seller.

2. Taxpayer will violate the normalization requirements of section 46(f) of the Code if Taxpayer's rate base or cost of service is reduced for the amortization of ITC's generated by Seller, not transferred to Taxpayer, and not subject to recapture at the time of sale.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this private letter ruling is being sent to your authorized representatives in accordance with the power of attorney on file with this office.

A copy of this ruling letter should be filed with the income tax return for the taxable year or years in which the transaction covered by this ruling is consummated.

Sincerely yours,

(signed) William J. Dwyer

William J. Dwyer
Chief, Branch 6
Corporation Tax Division

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Chairman RANGEL. Thank you.

Excuse me. We also have on our panel the distinguished chairman of the New York State Public Service Commission, Peter A. Bradford, accompanying Mr. Hagen. Do you have prepared testimony, Mr. Bradford? Because we would like to hear it.

Mr. BRADFORD. I do, Mr. Rangel.

Chairman RANGEL. OK. Mr. Bradford.

STATEMENT OF PETER A. BRADFORD, IMMEDIATE PAST PRESIDENT, NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS, AND CHAIRMAN, NEW YORK STATE PUBLIC SERVICE COMMISSION

Mr. BRADFORD. Thank you. My name is Peter Bradford. I am chairman of the New York State Public Service Commission. As Mr. Hagen noted, I am also the immediate past president of NARUC, the former chairman of the Maine Public Utilities Commission, and a former member of the Nuclear Regulatory Commission.

I appreciate the opportunity to testify in support of H.R. 1049. The passage of this legislation is one of NARUC's highest priorities. H.R. 1049 provides consumer benefits, economic efficiency, a more sensible Tax Code, and a more sensible allocation of responsibility between utility regulators and tax collectors.

The provision that H.R. 1049 will repeal was inserted in the Tax Reform Act late in the game. Indeed, this is the first full-fledged hearing ever held on it. Its anti-consumer impact was neither widely debated nor understood. The fact that it compels low-income customers and businesses in need of capital to make low-interest long-term loans to utilities, many of whom do not need the money for their own operations and are investing it instead in unrelated businesses, was not discussed at all.

The provision does not directly provide a single dollar of increased revenue to the Treasury. All it does is manipulate the flow of funds between utilities and their customers in ways favorable to utilities. It therefore has no legitimate place in the Tax Code.

Almost 20 years have passed since Federal tax laws began to impose mandatory normalization rules on public utility ratemaking. Since then, the definition of public utility normalization has expanded to an extent that it is now beyond all semblance of economic reality, and could more accurately be called abnormalization.

Ratemaking restrictions regarding investment tax credits have for many years prevented customers from getting their share of the benefits, have provided excessive profits for stockholders, and have encouraged excessive construction of power plants and biased utility power supply decisions away from energy conservation and less-costly power purchase arrangements. In an unfortunate expansion of this trend, the recently enacted Tax Reform Act adopted a provision requiring utilities to retain for many years ratepayer funds that will not be needed for payment of future taxes.

By restricting utility commissions from charging customers for actual tax expenses in ways that apply only to regulated enterprises, tax laws now prevent regulators from adjusting rates in con-

cert with the economic impact of Federal taxation on utilities. What is particularly disturbing about these developments is the fact that the tax laws have continually tightened restrictions on State commissions through the unique Federal version of normalization and, through the administrative processes of the Internal Revenue Service have built up an oversight authority that intrudes forcefully into utility ratemaking and policymaking for which the Treasury is incompetent and the States have extensive experience.

The reduction in tax rates to 34 percent essentially forgives a portion of the tax reserves so that they are no longer needed to pay taxes. They are not, as Mr. Steuerle claimed this morning, a tax benefit at all. They are a ratemaking overcollection. But for section 203(a), a State would treat them like, for example, a high oil price estimate that resulted in an overcollection for the fuel adjustment clause, an item to be returned on a realistic schedule to the customers.

Congress also set up a precise ratemaking scheme for amortization of the excess reserves, known as the average rate assumption method. This complex formula not only forces customers to lend money to utilities for decades, but it also requires utilities to add further increments to a reserve that is already overstated.

It is not surprising that these measures have aroused unanimous opposition in NARUC's membership. Tax Code attempts to impose normalization criteria beyond that which is required to satisfy future tax liabilities is tax fraud of a new sort, in which the Government allies itself with utilities to hold utility rates higher than they need to be.

The ratemaking treatment for excess past collections is not a tax issue. It is a consumer protection and a utility financial health issue. As such, it is within the expertise of the regulators and should not be subject to the arbitrary rules contained in section 203(e).

The basic Federal legislation prescribing normalization rules on public utilities came in the late 1960s, when utilities were generally a homogeneous group. Unit costs were declining due to economies of scale, rates were stable or decreasing, and utilities as a group enjoyed financial stability. The uniformity of the late 1960s has been replaced by the contrast of the late 1980s. Some utilities are on extremely precarious financial footing, while others carry gilt-edged bond ratings and generate far more cash than needed to pay utility businesses.

In New York, for example, utility bond ratings range from a high-quality triple A to speculative grade B. Such contrasts in financial quality do not justify a formula approach to the disposition of excess tax reserves, such as that contained in section 203(e). Regulators would never reach a similar decision. They would, instead, opt for refund schedules tailored to meet the financial needs of individual utilities.

In a related vein, cashflow that is not needed for utility purposes has become the fuel for diversification into nonutility fields. Diversification has become common in telecommunications, while cash-rich electric utilities also search eagerly for nonutility opportunities. Investment-rating agencies show recent year-to-year improve-

ment in the electric utility internal cashflow, a trend that should continue as the heavy construction period comes to an end.

Under these conditions, the retention of excess tax reserves only increases the likelihood that utilities will expand further into non-utility activities. Aside from the risks such ventures may impose on the regulated business segment, the retained dollars provided by ratepayers may end up invested in the nonutility business. This outcome is clearly detrimental not only to ratepayers but to potential competitors who have no similar Government-supported ability to conscript capital from monopoly customers.

Some utilities might need to borrow funds in order to make ratepayer refunds on the State-set schedule. But, contrary to the earlier testimony today, this is very unlikely. Many would not have to rely on external financing under normal regulation. As mentioned earlier, regulators will adjust the speed and timing of these refunds, usually by reducing rate increases rather than by ordering decreases, according to the financial strength of the individual utility.

In New York, for example, LILCO and Con Ed each owe about \$160 million to their customers. But, their financial circumstances are so different that regulation would not treat them identically.

Chairman RANGEL. I don't know how much more you have, but your time has expired. If you could summarize, it would be appreciated.

Mr. BRADFORD. All right. In summary, H.R. 1049 restores needed authority to State and Federal regulators and needed integrity to the Tax Code. It is an important step away from the attempts to set utility rates through the Internal Revenue Code, that have contributed to billions of dollars in excess plant construction in the electric industry alone.

NARUC has a broad diversity of outlook. It is politically bipartisan and its support of this bill is unanimous. We urge your strong support as well.

[The prepared statement follows:]

STATEMENT OF PETER A. BRADFORD, CHAIRMAN, NEW YORK STATE PUBLIC SERVICE COMMISSION, ON BEHALF OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Mr. Chairman and members of the Subcommittee:

My name is Peter Bradford. I am Chairman of the New York State Public Service Commission and I am also the immediate past President of the National Association of Regulatory Utility Commissioners. I appreciate the opportunity to testify in support of H.R. 1049.

Passage of this legislation is one of NARUC's highest priorities, for H.R. 1049 provides consumer benefits, economic efficiency, a more sensible tax code and a more sensible allocation of responsibility between utility regulators and tax collectors.

The provision that H.R. 1049 will repeal was inserted in the Tax Reform Act late in the game, without public hearings. Indeed, this is the first hearing ever held on it. Its anti-consumer impact was neither debated nor understood. The fact that it compels low-income customers and businesses in need of capital to make low-interest long term loans to utilities -- many of whom do not need the money for their own operations and are investing it instead in unrelated businesses -- was not discussed at all. The provision does not directly provide a single dollar of increased revenue to the Treasury. All it does is manipulate the flow of funds between utilities and their customers in ways favorable to utilities. It therefore has no legitimate place in the Tax Code.

1. Disposition of Excess Tax Reserves belong in the Regulatory Arena.

Almost twenty years have passed since federal tax laws began to impose mandatory "normalization" rules on public utilities. Since then, tax legislation has continually expanded the definition of public utility "normalization" to an extent that it is now beyond all semblance of economic reality and could more accurately be called abnormalization. Ratemaking restrictions regarding Investment Tax Credits have for many years prevented customers from getting their share of the benefits, have provided excessive profits for stockholders, and have encouraged excessive construction of power plants. Now, the recently enacted Tax Reform Act adopted a provision requiring utilities to retain for many years ratepayer funds that are not needed for payment of future taxes.

By restricting utility commissions from charging customers for actual tax expenses in ways that apply only to regulated enterprises, tax laws prevent regulators from adjusting rates in concert with the economic impact of federal taxation on utilities.

What is particularly disturbing about these developments is the fact that tax laws have continually tightened restrictions on regulated entities through the unique federal version of normalization and through the administrative processes of the Internal Revenue Service and have built up an oversight authority that intrudes forcefully into ratemaking and policymaking for which the IRS is incompetent and the States have extensive experience.

The Tax Reform Act of 1986 contains a new restriction on ratemaking practices by extending "normalization" rules to include excess deferred tax reserves caused by the reduction in tax rates from 46% to 34%. Utilities established these reserves to provide for the repayment in future years of certain front-loaded tax benefits, mainly accelerated depreciation. But the reduction in tax rates to 34% essentially forgives a portion of these reserves so that they are no longer needed to pay taxes.

Congress also set up a precise ratemaking scheme for amortization of the excess reserves known as the "average rate assumption method." This complex formula not only forces customers to lend money to utilities for decades, it also requires utilities to add further increments to a reserve that is already overstated.

It is not surprising that these measures have aroused the unanimous opposition of the NARUC's membership. Tax code attempts to impose "normalization" criteria beyond that which is required to satisfy future tax liabilities is tax fraud of a new

sort, in which the government allies itself with utilities to hold utility rates higher than they need to be.

The ratemaking treatment for excess past collections is not a tax issue. It is a consumer protection and utility financial health issue. As such, it is within the expertise of the regulators and should not be subject to the arbitrary rules contained in Section 203(e).

2. A generic disposition of Excess Tax Reserves fails to distinguish financial need.

The basic federal legislation prescribing normalization rules on public utilities came in the late 60's, when utilities were generally a homogenous group. Unit costs were declining due to economies of a scale, rates were stable or decreasing, and utilities as a group enjoyed financial stability. The uniformity of the late sixties has been replaced by contrasts of the late 1980's.

Some utilities are on extremely precarious financial footing while others carry gilt-edge bond ratings and generate far more cash than needed for their utility business. The cash-rich utilities have diversified into totally unrelated fields, while their financially weak brethren struggle to meet their public service obligations.

In New York, utility bond ratings range from high quality "AAA" to speculative grade B. Such contrasts in financial quality do not justify a formula approach for the disposition of excess tax reserves such as that contained in Section 203(e). It is highly unlikely the regulators would reach a similar decision, opting instead for a refund schedule tailored to meet the financial needs of individual utilities.

In a related vein, cash flow that is not needed for utility purposes has become the fuel for diversification into non-utility fields. Diversification has become common in telecommunications, while cash-rich electric utilities search eagerly for non-utility opportunities. Investment rating agencies show recent year-to-year improvement in electric industry internal cash flow, a trend that should continue as the current heavy construction period comes to an end. Under these conditions, the retention of excess tax reserves only puts more pressure on utilities to expand further into non-utility activities. Aside from the risks such ventures may impose on the regulated business segment, the retained dollars provided by ratepayers may end up invested in the non-utility business. This outcome is clearly detrimental not only to ratepayers but to potential competitors who have no similar government-supported ability to conscript capital from monopoly customers.

3. Utility arguments for uniform treatment are misleading

Some utilities might need to borrow funds in order to make ratepayer refunds on the state-set schedule. Others would not have to rely on external financing. As mentioned earlier, regulators will adjust the speed and timing of these refunds according to the financial strength of the individual utility. In New York, for example, LILCO and Consolidated Edison owe about \$162 million to their customers, but their financial circumstances are so different that regulation would not treat them identically.

But we are also sensitive to the fact that ratepayers have provided capital to pay taxes that now need not be paid. They should not have to wait decades for the opportunity to reclaim those funds. Ratepayers should decide for themselves how to spend their money. As Consumer Reports observed, "No matter how many good things your utility company proposes to do with your money, it's still your money."

The claim that uniform treatment of excess deferred taxes is necessary for accounting purposes is nonsense. Allocations across jurisdictional boundaries is prevalent in the telephone industry for separation of financial data between interstate and intrastate jurisdictions. Utilities with multi-state service areas must also cope with allocations on investment, revenues and expenses among the various jurisdictions. Accounting and ratemaking differences invariably exist with respect to such

practices as CWIP in rate base, depreciation, and even tax normalization policies. There is no reason to believe that different refund periods for excess deferred taxes could not be accommodated just as easily.

Thank you for this opportunity to testify on this important legislation.

WRITTEN REMARKS

INTRODUCTION

Since the landmark tax legislation of 1969, tax laws have steadily limited regulators' ability to adjust rates in concert with the economic impact of Federal taxation on utilities. With each new revision it becomes increasingly clear that the political muscle of the utility lobby has seriously eroded the ability of regulators to balance ratepayer and stockholder interests and has created huge economic distortions between regulated and nonregulated corporations. The new tax "reforms" contained in the Tax Reform Act of 1986 (TRA-86) impose ever more restrictive regulatory policies that further widen the gap between measurement standards imposed on utilities and those used by their nonregulated counterparts.

Although nonregulated corporations escape the rigors of compliance with tax law restrictions in price setting, they must apply similar normalization mechanism in accounting for Federal income taxes. The guidelines used in the private sector, like tax law restrictions on utilities, have their roots on generally accepted accounting principles, and in that sense, private sector enterprises are bound on similar constraints that govern utility accounting and rate making. However, as Congress tightens the rules for utilities, they move further away from the standards under which other enterprises must measure tax benefits.

The present criteria mandated by Federal tax laws for pricing utility services are more stringent than the standards all other corporate enterprises must meet in measuring the effect of tax benefits provided by investment tax credits and accelerated depreciation. Under soon to be released standards applicable to the private sector, companies may flow through tax benefits related to investment tax credits and excess deferred taxes immediately, while public utilities must recognize those same benefits over the life of the related property. The Tax Reform Act of 1986 contains the latest encroachment of utility ratemaking practices by prohibiting any faster flow back of excess deferred taxes caused by the reduction in tax rates from 46 to 34 percent.

While critics may argue that pricing in the private sector has no relationship to accounting standards, it is the accountants who determine how economic events are translated into monetary values, and ultimately into prices for goods and services. The Federal preemption of utility ratemaking creates an artificial prop under utility prices, causing economic distortions for some customers. There is a double standard for achieving the capital formation goals of Federal tax policy, which is not justified by economic theory of societal goals.

ACCELERATED DEPRECIATION & EXCESS TAX RESERVES

Accelerated depreciation is a timing difference in tax and accounting parlance, and all corporations normally establish a reserve for payment of tax liabilities for use when the front-loaded deductions reverse in later years. Under the procedure, entities report higher income tax expense in early years than actually is paid to the Treasury. For public utilities, Federal tax laws prescribe that the higher level of tax expense must be included in rates; utility earnings are not enhanced because the tax reserves are deducted from rate base, or treated as zero cost capital.

Under both current accounting standards used in the private sector and Federal tax requirements, the reserves are established at tax rates in effect in the year the benefits are realized. However, when tax rates change, such as the TRA-86 reduction in

rates from 46 percent to 34 percent, a portion of the tax benefits realized at 46 percent is essentially forgiven, and the timing difference becomes a permanent difference. A portion of the previously established reserves are no longer needed for their stated purpose.

Under proposed accounting standards scheduled to be issued in the fall of 1987, private sector corporations will be able to reduce their deferred tax reserves to reflect the current tax rate. These excess reserves may be used to increase earnings or reduce prices. However, TRA-86 not only prevents the current recovery of excess reserves by utilities, but actually expands the mandatory criteria for complying with normalization. Under the rules contained in Section 203(e), utilities would delay refunding excess collections to a rate no more rapid than the remaining book life of the property, using a complex formula known as the "average rate assumption" method.

Section 203(e) of the reform package was quickly flagged by NARUC and consumer groups as an extraordinary new incursion into the rate-setting process. However, the overwhelming complexity of the entire reform package and the rapid momentum of the bill through the congressional process allowed for virtually no opportunity to correct this narrow and highly technical provision which few understood to begin with.

Thus, under the most optimistic scenario, utility customers who have paid some \$19 billion of excess deferred taxes will now have to wait decades to be fully compensated for the overcharge. Older citizens and shaky businesses will not live so long, and utility regulators who seek to advance the refund schedule by ordering quick refunds as they have done in the past will find that utilities will no longer qualify for the use of accelerated tax depreciation because that treatment violates the new normalization requirement.²

H.R. 1049

Therefore, I support H.R. 1049 which seeks an outright repeal of Section 203(e) to return to regulators the determination of the most appropriate refund period for excess deferred taxes on a case-by-case basis. Utilities which seek to retain deferred taxes over a prolonged period would have every opportunity to make their case in the open forums of the various State and Federal commissions. To date, the legislation has attracted a bipartisan coalition of some 44 House co-sponsors. Dorgan's bill mandates no particular accounting technique or refund schedule. It merely changes the locus of decision making from Congress back to those lawfully charged with setting utility rates.

Uncomfortable that regulators might be restored the discretion to order timely reimbursements to customers of financially healthy utilities, the utility lobby has set to work to defeat the legislation. In response to the plethora of novel arguments now being advanced by the lobby opposed to the legislation, a few points are in order.

First among these is that the effective practice of public utility regulation demands that the allowed rates of each regulated entity be established according to the unique circumstances associated with each company. The art of regulation involves complex negotiation in an effort to strike the proper balance between stockholders and ratepayers. The utility lobby's success lies in the fact that it has been able to remove from the bargaining table significant matters which in the past have been left to the discretion of regulators.

While some utilities admittedly are on shaky ground financially, others carry gilt-edge bond ratings and generate far more cash than needed for their utility business. The cash-rich utilities have diversified into totally unrelated fields while their financially weak brethren struggle to meet their public service obligations.

Despite these differences, the 1986 Tax Reform Act treats each firm in an identical manner. Each will be allowed to delay the refund of tax overcharges for many years to come. Given the magnitude of the dollars involved, it is highly unlikely that a

similar decision would be reached by regulators. More likely, regulators would take into account the financial health and needs of each of the firms and adjust the refund schedule accordingly.

The Edison Electric Institute commissioned the accounting firm Deloitte Haskins & Sells to conduct a detailed study on the policy aspects of Section 203(e).³ The report, prepared for use as a lobbying tool, acknowledges that more rapid refunds lower the utility cost of service to ratepayers over both the short and long run. However, the report argues that lost Federal tax revenues due to rapid refunds is contrary to the public interest. Interestingly, the Joint Committee on Taxation has already issued a revenue estimate on the Dorgan bill and concludes that the bill, "would not have any significant revenue impact on the Federal Treasury."⁴

The more important point to be made, however, regarding the DHS study is that the firm used a 10 percent discount rate in reaching its conclusions. Had the discount rate been adjusted to acknowledge a higher and more realistic cost of borrowed funds (particularly for residential consumers) the study results would have been even more skewed in favor of allowing rapid refunds. This point is critical for one must bear in mind that excess tax reserves represent an involuntary loan from ratepayers to utility stockholders--a loan which ratepayers would prefer to be repaid sooner rather than later. A shorter refund period makes additional investment capital available to the recipient customer--a point which has not gone unnoticed by large industrial customers whose refunds would be substantial. The General Motors Corporation, for example (a supporter of the Dorgan bill), estimates that its refunds nationally will be in the range of \$80 to \$100 million.⁵ Involuntary loans to utility companies do not sit well with firms struggling to meet the demands of foreign competition.

Utilities argue that the funds are not readily available for refund and that new loans would be required to offset the demands of a rapid refund schedule. While this is generally true, State regulators are better able to evaluate the impact of various amortization options on specific utilities, rather than having to conform to one mandatory procedure that is clearly not necessary in all cases. As Consumer Reports observed, "No matter how many good things your utility company proposes to do with your money, it's still your money. Large windfalls shouldn't be allowed to fall into the never-never land of utility-company balance sheets."⁶

THE CUP IS FULL

In the past the utilities have had a ready argument to justify the roughly \$73 billion in "taxes" collected from ratepayers but not yet paid the Treasury. The argument--normalization theory--has been given wide credibility by several of the "Big Eight" certified public accountant firms which have been only too willing to offer supportive testimony at congressional hearings or State regulatory proceedings on an "as needed" basis.

Not content with the billions in Federal tax subsidies already garnered, the utility lobby is now sharpening its knives for yet another slice of Federal largess. Once again ratepayers will be the clear losers.

If the utility lobby has its way, an oversight in the 1986 Tax Reform Act may actually allow for the collection of additional billions from ratepayers in the name of "Federal taxes" which bear absolutely no relationship to the actual present or future tax obligation of the industry.

Little attention has been paid to the fact that although the new lower corporate rate is now in effect (as of July 1, 1987), additional deferred taxes continue to be accrued above and beyond that which will be required to cover the industry's future liability. In an article published in Tax Notes, Professor Joseph W. Jacobs of Florida State University College of Law and his colleague, Mr. Thomas O. Mittelsteadt, a Federal corporate income tax expert, estimate that an additional \$15 to \$20 billion in needless additional reserves will be collected from ratepayers

unless an ambiguity in the 1986 Tax Reform Act is clarified.⁷

In order to appreciate the mechanics of this new subsidy simple hypothetical case examples must be employed. All public utility depreciable property which has a tax life less than its regulatory life creates deferred Federal income taxes. Cases Nos. 1 and 2 document the year-to-year deferred tax balances which are associated with a hypothetical utility asset which is depreciated either under a stable 46 percent corporate rate or a stable 34 percent corporate rate. In both instances the deferred tax balances zero-out at the end of the regulatory life of the asset.⁸

As shown in Case No. 1, the maximum deferred tax balance associated with the hypothetical asset under the 46 percent rate is \$230,000. Assuming a stable 34 percent corporate rate (Case No. 2) the maximum deferred tax balance is \$170,000. The deferred tax balance "peaks" at the midpoint or crossover point of the asset life, which in the example is precisely the moment when the asset is fully depreciated for tax purposes but only 50 percent depreciated for regulatory book purposes.⁹ With each year the deferred tax balance diminishes till it reaches zero at the end of the regulatory life of the asset. At no point does the deferred tax balance ever exceed the amount which will eventually reverse to zero; i.e., under stable tax rates, there are no excess deferred taxes.

However, if the corporate tax rate is cut at any point in the asset's life, the accumulated deferred tax balance will be in excess of that required to cover the tax obligation associated with the asset, and ratepayers will be due a refund. This is what the battle over the Dorgan bill has been all about to date.

The problem is somewhat complex to those assets which have not yet reached the midpoint or point of reversal. In Case No. 3 the tax rate is reduced at the end of the fourth year of the ten-year asset life. At this point \$184,000 in deferred taxes have already been collected from ratepayers. Had the corporate rate been a constant 34 percent from day one, the deferred tax balance at the end of the fourth year would have been only \$136,000 as was shown in Case No. 2. Thus ratepayers have overpaid the taxes associated with this asset by \$48,000.

Note further that the \$184,000 balance is already \$14,000 higher than the \$170,000 which will be needed to cover the full tax liability of the asset under the new 34 percent rate. Stated differently, ratepayers have already paid more than enough in taxes after four years to cover the entire tax liability that will ever be associated with this asset.

Yet by blindly following the old normalization rules for year five and thereafter, an additional \$34,000 in new deferred taxes will be collected even though it is known in advance that these funds will never have to be paid to the Treasury and will only have to be repaid to ratepayers. This clearly exceeds the bounds of reason or common sense yet this is precisely the interpretation of the 1986 Tax Reform Act that the utility lobby is promoting at meetings with the Internal Revenue Service today.

Congress never consider or intended such effects. In the article referenced above, authors Jacobs and Mittelsteadt argue that the entire concept of normalization hinges on the integrity of the deferred tax account, meaning simply that the reserve must be adequate to cover the eventual tax liability but that, "Nothing in normalization doctrine requires the creation or funding of excess reserves above and beyond the amount of those projected liabilities. 'Normalization' should not be used as a boilerplate umbrella to justify and support actions which are unrelated to its precepts."¹⁰

A regulatory question thus arises as to whether or not the definition of "normalization" as provided in Internal Revenue Code Sections 167(l) and 168(e), and Section 203(e) of the 1986 act will allow for ratemaking techniques which stop the accrual of new deferred taxes when the deferred tax balance reaches the level needed to fund the tax liability associated with the asset. In Case No. 3, ratepayers would clearly prefer that no new accruals of deferred taxes be allowed, for to do otherwise would require ratepayers to pay the utility funds which will only have to be returned to them at some point in the murky future.

CASE NO. 1

ASSUMPTIONS: \$1,000,000 Asset; 5 year tax life;
10 year book life; 46% tax rate

YEAR	TAX RATE	TAX DEPRECIATION	BOOK DEPRECIATION	TOTAL ACCUMULATED DEFERRED TAXES	PORTION OF DEF. TAXES WHICH ARE "EXCESS"
1	46%	\$200,000	\$100,000	\$46,000	\$0
2	46%	\$200,000	\$100,000	\$92,000	\$0
3	46%	\$200,000	\$100,000	\$138,000	\$0
4	46%	\$200,000	\$100,000	\$184,000	\$0
5	46%	\$200,000	\$100,000	\$230,000	\$0
6	46%	\$0	\$100,000	\$184,000	\$0
7	46%	\$0	\$100,000	\$138,000	\$0
8	46%	\$0	\$100,000	\$92,000	\$0
9	46%	\$0	\$100,000	\$46,000	\$0
10	46%	\$0	\$100,000	(\$0)	\$0

CASE NO. 2

ASSUMPTIONS: \$1,000,000 Asset; 5 year tax life;
10 year book life; 34% tax rate

YEAR	TAX RATE	TAX DEPRECIATION	BOOK DEPRECIATION	TOTAL ACCUMULATED DEFERRED TAXES	PORTION OF DEF. TAXES WHICH ARE "EXCESS"
1	34%	\$200,000	\$100,000	\$34,000	\$0
2	34%	\$200,000	\$100,000	\$68,000	\$0
3	34%	\$200,000	\$100,000	\$102,000	\$0
4	34%	\$200,000	\$100,000	\$136,000	\$0
5	34%	\$200,000	\$100,000	\$170,000	\$0
6	34%	\$0	\$100,000	\$136,000	\$0
7	34%	\$0	\$100,000	\$102,000	\$0
8	34%	\$0	\$100,000	\$68,000	\$0
9	34%	\$0	\$100,000	\$34,000	\$0
10	34%	\$0	\$100,000	(\$0)	\$0

CASE NO. 3

ASSUMPTIONS: \$1,000,000 Asset; 5 year tax life;
10 year book life; 46% tax rate which is
reduced to 34% at the end of the 4th year.

YEAR	TAX RATE	TAX DEPRECIATION	BOOK DEPRECIATION	TOTAL ACCUMULATED DEFERRED TAXES	PORTION OF DEF. TAXES WHICH ARE "EXCESS"
1	46%	\$200,000	\$100,000	\$46,000	\$0
2	46%	\$200,000	\$100,000	\$92,000	\$0
3	46%	\$200,000	\$100,000	\$138,000	\$0
4	46%	\$200,000	\$100,000	\$184,000	\$46,000
5	34%	\$200,000	\$100,000	\$230,000	\$46,000
6	34%	\$0	\$100,000	\$174,400	\$38,400
7	34%	\$0	\$100,000	\$130,800	\$28,800
8	34%	\$0	\$100,000	\$97,200	\$19,200
9	34%	\$0	\$100,000	\$63,600	\$9,600
10	34%	\$0	\$100,000	\$0	\$0

The 1986 Tax Reform Act is silent on the question of whether or not "normalization" as it is currently defined requires the accrual of deferred taxes for public utility property whose deferred tax balance already equals or exceeds the total deferred taxes required under the new 34 percent corporate rate.

The Nevada Public Service Commission has taken the lead on this question and has already met with officials at the Internal Revenue Service to discuss the matter. Deloitte Haskins & Sells represented the industry view at that meeting and reported their interpretation of the tentative IRS position in their August 7, 1987, edition of "Public Utility Executives Briefs." According to the newsletter, "The IRS concluded by saying that 'originating timing differences' and 'reversals' are subject to related, but different requirements. Utilities may not stop normalizing, just because their reserve is at a sufficient level to provide for deferred tax liabilities."¹¹

If this preliminary IRS view holds up when final regulations are issued, ratepayers will be forced to pay billions in needless new involuntary loans to their local utility companies. Commissions should ignore this preliminary view and challenge it in court if that becomes necessary. The IRS is simply incompetent to set public utility prices to customers, and its views on this subject are entitled to no special weight.

Congressman Dorgan's legislation is an important effort to return to utility rate setters a small but significant portion of the consumer protection which the Internal Revenue Code has nullified over the years. The New York State Public Service Commission and the NARUC support H.R. 1049 whole heartedly.

ENDNOTES

1. The Executive Committee of the National Association of Regulatory Utility Commissioners unanimously adopted a resolution at its summer, 1985, meeting in San Francisco which specifically opposed any language in the tax reform package which would have the effect of restricting the ability of regulators to order refunds of excess deferred tax balances. The text and intent of that resolution was included in the testimony of the NARUC to the House Committee on Ways and Means and to the Senate Finance Committee.
2. Note that the restrictive language of Section 203(e) is applicable to depreciation related tax-to-book timing differences only. Regulators may order the flow through of other excess deferred taxes as rapidly as they choose without violating the normalization requirements. The Congressional Research Service has estimated that in the electric utility industry, perhaps as much as 25 per cent or more of the total industry excess deferred tax balances are non depreciation-related and thus may be flowed through to customers. (See Kiefer, "The Effects of Tax Reform on Public Utilities," Tax Notes, June 1, 1987, p. 899.)
3. "The Case for Normalizing the Excess Tax Reserves of Public Utilities," by Thomas Horst and Emil M. Sunley, Deloitte Haskins & Sells, as published in Tax Notes, (June 29, 1987), p. 1330.
4. Letter from David H. Brockway, chief of staff, Joint Committee on Taxation to U.S. Representative Byron Dorgan, April 3, 1987.
5. "Dorgan & Company versus the Utilities," Tax Notes, (June 1, 1987), p.827.
6. "New Tax Laws Should Lower Your Utility Bills," Consumer Reports, (August, 1987) p. 466.
7. "Excess Tax Reserves and the Tax REform Act of 1986," by Joseph W. Jacobs and Thomas O. Mittelsteadt, Tax Notes (June 29, 1987), pp 1399-1344.

8. In the single asset example employed here deferred taxes are shown as being paid to the Federal Treasury. In actual practice, as has now been extensively demonstrated, a stable or growing utility is able to offset the payment of the deferrals with new deferrals as new assets are purchased. Thus, the total accumulated deferred tax balance increases rapidly over time.

9. In actual practice the crossover point or point of reversal may or may not be at the precise midpoint of the asset's life. The examples contained here simplify the accounting techniques involved but accurately describe the fundamental principles.

10. Ibid., p. 1344.

11. "IRS Addresses Excess Deferred Tax Issue," Public Utility Executive Briefs, Deloitte Haskins & Sells (August 7, 1987), p.8.

Chairman RANGEL. Thank you.
Mr. Barasch of Pennsylvania.

STATEMENT OF DAVID M. BARASCH, PRESIDENT, NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES, AND CONSUMER ADVOCATE FOR THE COMMONWEALTH OF PENNSYLVANIA

Mr. BARASCH. Thank you, Mr. Chairman.

On behalf of the National Association of State Utility Consumer Advocates and the Pennsylvania Consumer Advocate's Office, I want to thank you for the opportunity to appear here today.

Currently, I serve as consumer advocate for the Commonwealth of Pennsylvania, a State agency mandated by our general assembly to represent consumers before the Pennsylvania Public Utility Commission and comparable Federal agencies and courts. I also serve as president of NASUCA. NASUCA is a national organization composed of members from 38 States and the District of Columbia. Our member officers are all designated to represent the public utility ratepayers before State and Federal regulatory authorities and appellate courts.

We strongly support the repeal of section 203(e) of the Tax Reform Act. Section 203(e) inappropriately usurps State regulatory authority, and is unfair to residential, commercial and industrial consumers alike, by forcing them to make involuntary loans to the Nation's utilities of at least \$19 billion in excess tax payments for many years to come.

Ironically, the issue that H.R. 1049 seeks to address arose from one of the most positive aspects of the Tax Reform Act of 1986, that is the drop in the corporate tax rate from 46 to 34 percent. This change generally resulted in the reduction in the amount of tax expense that ratepayers were required to pay to their utilities. This rate reductive effect is currently being addressed by public utility commissions and consumer advocates alike around the country. Our national association, NASUCA, recently conducted a survey which I think conclusively demonstrates considerable diversity in the way that the TRA-86 reforms are being handled by the various State regulatory commissions.

But there is one area where such State by State flexibility has been banned, and that is the treatment of excess deferred income taxes under section 203(e). As a result of this 46 to 34 percent drop, approximately 26 percent of the deferred taxes previously charges ratepayers by the Nation's utilities are no longer required to be paid to the Federal Government. We estimate that the excess deferred tax balances held by utilities nationwide are now at least \$19 billion. In Pennsylvania, to use one example, the size of these excess payments may be as much as \$1 billion.

I think a brief explanation of what the debate over normalization or nonnormalization is all about. I would agree with Congressman Dorgan, the issue here is not a question of tax normalization, it is rather a question of how fast this money is returned to the public, and whether State regulatory commissions have the discretion to tailor their responses to the individual financial needs of the utilities.

Normalization, as we know it, requires the accelerated depreciation advantages allowed in sections 167 and 168 of the Internal Revenue Code, cannot be immediately passed on to utility ratepayers. Instead, ratepayers pay income tax expense using book amounts as if these tax benefits did not exist. The difference is placed in a deferral account. The extra tax expense subsequently is returned to ratepayers when the tax depreciation turns around. That is, when tax depreciation falls below book depreciation.

The turnaround amounts are paid as an additional expense to the Federal Government at the statutory rate in effect at the time that the turnaround occurs. When the turnaround tax rate is lower than the rate at which the tax expense was originally deferred, the difference between the tax expenses at the deferral rate and the tax expense at the current rate creates the excess deferred taxes, the subject of this legislation. These are moneys that will never be paid to the Federal Treasury. And absent some accounting or regulatory guidance, these excess balances will remain in deferral accounts and in the hands of utilities forever.

Since these excess deferred taxes have nothing to do with the Federal Government's normalization policy, be it a good policy or a bad policy, traditionally they've been treated by each State, and each State has tailored its response to the individual situation. In response to tax rate reductions, while some States have adopted an approach similar to that mandated by TRA-86, other States have required that the excess deferrals be flowed back to ratepayers over periods ranging from 1 to 10 years.

Section 203(e) effectively prohibits States from exercising this discretion. Instead, it mandates a specific treatment for the return of the excess deferred tax balances regardless of the utility at issue or the individual circumstances involved. In most cases, these balances will not be returned except over an extended period of time, perhaps 15 to 40 years, depending upon the average remaining service life of the asset that gave rise to the tax benefit in the first place.

Finally, there's another hidden difficulty contained within the present Tax Code, and that is that the method chosen by section 203(e) to return these balances, the average rate assumption method, acts perversely to permit utilities to continue to fund and thus increase their deferred tax balances prior to the reversal point, even though and even if the existing deferred balances may already be at a point that would permit the total payback of the tax deferrals as required by the tax laws. On the chart over there, the red area in the curve explains how that works, and if there are questions, I would be happy to explain that later.

Summarizing, we believe that H.R. 1049 is an extremely important piece of legislation. First, it corrects something that is very seriously wrong in the Tax Reform Act of 1986. That is, the Federal Government has usurped the traditional regulatory powers of the States. Even though we are consumer advocates often at odds with our regulatory commission, we certainly think they are in a much better position to judge what is best for the utilities and the consumers than the Department of Treasury is.

Second, this Federal usurpation is totally unnecessary because the ratemaking treatment that we're talking about here is the

treatment of excess deferred taxes. Allowing for the fast return of these deferrals will not undermine in any way the Federal Government's present policy on tax normalization, whether I happen to agree with that policy or not.

Third, section 203(e) requires a forced, at a less than fully compensatory, rate of interest, loan by hard-pressed ratepayers to the utilities. Certainly the utilities have other means of raising capital if they need to. I don't think that, in many cases, there is that need.

And, finally, it's important to realize that, contrary to the statement made by the Treasury Department witness, TRA-86, section 203(e), treats utility companies quite differently than unregulated companies. In the unregulated market, in the competitive market, if a major fall occurs in the cost of producing a product, there will be a direct consequence in the price of that product. Failure to reflect that change in the cost of service would make that company noncompetitive.

For example, if a gas station tried to keep the price of gasoline at \$1.90 a gallon, while its competitors cut the price to \$1 a gallon, obviously they're lose business. So, in fact, in the rest of the marketplace, the benefits of the Tax Reform Act and any excess deferred taxes will in fact be flowed back to the consumers who purchased the goods and services of those utilities, of those companies.

Unfortunately, in the area of regulated utility service, the section 203(e), will unnecessarily restrict the flowback of that money to the public.

In summary, we support the passage of H.R. 1049.

[The statement follows:]

STATEMENT OF DAVID M. BARASCH

On behalf of the National Association of State Utility Consumer Advocates (NASUCA) and the Office of Consumer Advocate of the Commonwealth of Pennsylvania, I want to thank you, Mr. Chairman, and members of the Subcommittee for this opportunity to appear here today to add our support for H.R. 1049, a bill which would repeal Section 203(e) of the Tax Reform Act of 1986 (TRA-86).

Currently, I serve as the Consumer Advocate of the Commonwealth of Pennsylvania, a state agency mandated by the General Assembly of that Commonwealth with the responsibility to represent consumers before the Pennsylvania Public Utility Commission and comparable federal agencies on all utility related matters. I also serve as President of NASUCA. NASUCA is a national organization composed of members from 38 states and the District of Columbia. The member offices of NASUCA are designated to represent public utility ratepayers before regulatory authorities and appellate courts.

The members of our organization have considerable experience in utility rate cases that are decided every day before state and federal administrative agencies and courts. Through that experience we have developed considerable expertise in the financial and operational characteristics of public utilities. Accordingly, we believe we can provide useful information to this Subcommittee to assist it in considering this important issue.

NASUCA strongly supports the repeal of Section 203(e) of the Tax Reform Act. As I will explain, that section inappropriately usurps state regulatory authority and is unfair to residential, commercial and industrial consumers alike, forcing them to make an involuntary loan to the nation's utilities of at least \$19 billion in excess tax payments for years to come.

As you know, the issue that H.R. 1049 seeks to address was one that grew out of one of the more salutary aspects of TRA-86: the drop in the corporate tax rate from 46% to 34%. The reduction in the corporate tax rate generally resulted in a reduction in the amount of tax expense that ratepayers were required to pay in their utility rates. This rate reductive effect, along with the offsetting effect of increases in taxable income for other items, are being addressed by public utility commissions throughout the country. From our survey of how each jurisdiction is responding, it is clear that the various states are showing considerable diversity in handling the effects of TRA-86 that are within their power to review.

There is one area, however, where such state by state flexibility has been banned: the treatment of excess deferred income tax balances under Section 203(e). As a result of the reduction in the corporate tax rate, a considerable amount of deferred taxes previously charged to ratepayers by the nation's utilities are no longer required to be paid to the federal government. It is estimated that the excess deferred tax balances now being held by utilities nationwide are at least \$19 billion. In Pennsylvania, to use one example, the value of these excess payments may be as much as \$1 billion. These excess reserves represent approximately 25% of the dollars that ratepayers have paid to utilities as a result of the mandated normalization of accelerated depreciation tax preferences permitted by the Internal Revenue Code.

Normalization requires that the accelerated depreciation advantages allowed by §§167 and 168 of the Internal Revenue code cannot be immediately passed on to ratepayers. Instead ratepayers must pay income tax expense using book amounts, as if these tax benefits do not exist. The difference in tax is placed in a deferral account. The extra tax expense subsequently is returned to ratepayers when the tax depreciation "turns around," that is, when the tax depreciation falls below book depreciation.

The above discussed "turn around" amounts are paid as an additional expense to the federal government at the statutory rate in effect at the time that the "turn around" occurs. When the "turn around" tax rate is lower than the rate at which the tax expense was originally deferred, the difference between the tax expense at the deferral rate and the tax expense at the current rate creates excess deferred taxes which will never be required to be paid to the Federal Treasury. Absent some accounting and regulatory guidance, these excess balances would remain in the deferral accounts, and in the hands of the utilities, forever.

Because these excess deferred tax balances have nothing to do with the federal government's normalization policy, they have, in the past, been treated by each state jurisdiction in a manner that best reflected that state's overall regulatory policy and goals. As a result, in response to past tax rate reductions, while some states have adopted an approach similar to that mandated in the Tax Reform Act of 1986, others have required that the excess deferrals be flowed back to ratepayers over periods ranging from 1 to 10 years.

Section 203(e), effectively prohibits states from exercising their discretion in this salutary manner. Rather, it mandates a specific treatment for the return of the excess deferred tax balances created by TRA-86, regardless of the utility at issue or the individual circumstances involved. In most cases, the method requires that the balances will not be returned, except over an extended period of time--usually 15 to 40 years -- depending upon the average remaining service life of the property involved.

Finally, the method chosen by Section 203(e) to return these balances--the Average Rate Assumption Method (ARAM), acts perversely to permit utilities to continue to fund, and thus increase, their excess tax deferral balances prior to the "reversal" point, even though the deferral balances may already be at a point which would permit the total payback of tax deferrals required by the tax laws.

As practitioners in the utility regulatory field, and as statutory representatives of the consumers who have funded these considerable balances, we are aware of no valid argument for continuing the limitation on state regulatory authority imposed by Section 203(e). There are a number of reasons why Section 203(e) should be repealed.

First, the intrusion by federal legislation into the regulatory prerogatives of individual state commissions is notable in its extreme rarity. The major exception to this rule is in the area of normalization of accelerated depreciation and investment tax credits. These limitations, it is generally acknowledged, were initially enacted to assure that the tax incentives provided by Congress to promote expansion of business facilities and services would also be available to utilities to be utilized for that purpose. Beyond those narrow examples, Congress has refrained from mandating a particular state regulatory treatment for what is simply a ratemaking issue, and quite appropriately so. As a general principle, we believe that state ratemakers are in the best position to judge the individual circumstances affecting their utilities and to determine the appropriate ratemaking treatment for individual items, including excess deferred taxes.

Second, the treatment of excess deferred tax balances has no relevance to the question of normalization of accelerated depreciation. To the extent that Congress intended to provide tax benefits to firms, including utilities, to help finance expansion of facilities and services, those tax benefits have been provided in the past and have been funded by ratepayers at the then current statutory amount. Thus, the excess deferrals are over and above any additional capital that Congress may have desired to provide to utilities through the mandate of normalization accounting. Furthermore, to the

extent that the normalization provisions of the Internal Revenue Code were designed to assure that utilities had adequate funds available to fund the tax benefits provided under the Code, that goal is unaffected by the treatment of excess deferred taxes.

The inapplicability of the normalization rules to excess deferred tax balances is pointed up by the United States Treasury's determinations on previous excess deferred tax balances created by the 1978 reductions in the corporate tax rate from 48% to 46%. In considering whether a rapid amortization of these excess deferred balances would in any way violate the Internal Revenue Code, the Treasury Department indicated that the excess deferred tax balances were quite different in nature from the deferred taxes required to be maintained pursuant to the normalization provisions of the IRC and therefore were not similarly subject to the normalization requirements.*

Third, Section 203(e) mandates a forced loan to utilities from its ratepayers at an interest rate which is not compensatory. The Average Rate Assumption Method mandated by TRA-86 requires that the forced loan -- the excess deferred balances -- not be repaid to ratepayers any faster than over the average remaining service life of the assets in question, and then only after the accelerated depreciation account has reached its "reversal" point. This means that in many instances the excess deferred taxes will actually continue to grow for many years into the future before they reach the "reversal" point. A total return of the excess deferred balances could take anywhere from 15 years for telephone companies to 40-50 years for water companies.

As a result of this delay, the ratepayers who paid the excess taxes, in all likelihood, will not be the same ratepayers who receive the refund many years later. Moreover, during this period of time, ratepayers will receive only the return reflecting the company's overall cost of capital on its considerable forced "loan" to the utilities. That amount will be approximately 10 to 12%. A comparable "discount rate" for residential customers is generally considered to be in the range of 15 to 18%, reflecting the interest rate on revolving credit accounts. For commercial and industrial customers, many of whom are struggling to make ends meet, their discount rate could be infinite, reflecting the fact that a reduction in utility rates today could mean the difference between viability and extinction. Even for those competitive firms not experiencing financial difficulties, certainly their management would far prefer to have a choice of how they invest their marginal available funds.

We think it is safe to conclude that most of us would rather have the use of our money today, as opposed to being forced to defer receipt for many years into the future, even if a moderate interest rate were being provided.

Fourth, the methodology prescribed for utilities in TRA-86 is inconsistent with the way the unregulated market would deal with these excess deferred tax balances. To the extent possible, utility regulation generally attempts to act as a surrogate for the competitive market. Our understanding is that unregulated companies may write down these balances to income in the year in which they are created. If unregulated companies take this action and are participating in competitive markets, they will have to reflect these reductions in the prices they charge for their products or services. A rapid amortization of these excess deferred balances, therefore, would appear to be much more consistent with the way in which unregulated firms would deal with these balances in competitive markets.

* Private Letter Ruling No. 8544061 (August 6, 1985).

Another economic inefficiency created by Section 203(e) is that by requiring that the payback of these excess amounts can only occur over a long period of time those commercial and industrial customers who vigorously invest in conservation or alternative means of energy supply to hold down rising utility rates will receive far less of a share of these refunds than they initially contributed.

Finally, as noted above, the long pay back period mandated by §203(e) will create inter-generational inequities, since many of the ratepayers who funded these excess tax balances may no longer be customers when these funds are finally returned.

In summary, Mr. Chairman, NASUCA believes that TRA-86's Section 203(e) should be repealed because it is unfair to ratepayers, unnecessarily intrusive into state ratemaking authority and may promote anticompetitive and inequitable results. It must be emphasized that the repeal of Section 203(e) would do no more than permit each state utility commission to determine the most appropriate means of dealing with these excess balances. While some states might choose, and we think appropriately so, a rapid amortization of the excess deferrals, other commissions may decide that the average rate assumption method is the most appropriate. Furthermore, the regulatory treatment of these items may vary from company to company depending on the particular financial circumstances facing each.

This flexibility of regulatory response is one of the most positive aspects of the regulatory structure that governs utility operations in the United States today. In our view, it serves ratepayers and utilities well overall. I know of no reason why the state regulatory process should not be permitted to address and resolve the matter of excess deferred taxes as well.

Mr. FLIPPO [presiding]. Thank you very much, gentlemen, for your testimony.

Without objection, I have a statement that I would like to include in the front part of these hearings at this time.

The gentleman from New York reserves the right to object.

Let me ask you—well, I see our chairman has arrived.

Chairman RANGEL. Go right ahead.

Mr. FLIPPO. Let me ask you that if regulators were free to flowthrough these excess reserves, would they have to follow a single policy with respect to all utilities subject to their jurisdiction or could the rules be different for firms in different circumstances?

Mr. HAGEN. Mr. Chairman, I think, looking at North Dakota, we would probably try to handle them all alike, but we might do any number of things.

We might normalize. We did normalize in 1978. We might flowthrough. We might have a variety of that. I think it's pretty much wide open. I think that's one reason you would like to have, as I see it, State regulators handle this because they are in a position to look at just what kind of condition those companies are in.

Mr. Bradford might have a comment too.

Mr. BRADFORD. I agree with what Mr. Hagen said. There's no question that not only would practices differ among States, they would differ to some degree within States as well, depending on the financial circumstances.

Mr. FLIPPO. In other words, you would like the authority to use a flowthrough for one and use a normalization for another, depending upon the financial condition, or generally the financial condition of the firm at the time.

Mr. BRADFORD. Basically that's right. There might be other considerations as well, but the fact of the matter is that the general principle we follow is that when utilities wind up with dollars belonging to their customers, and this happens fairly often in utility regulation through, for example, an overestimate of the cost of doing service in fuel cost area. The money should go back to the customers as quickly as possible, consistent with principles of rates, stability and financial security of the company.

Mr. FLIPPO. Mr. Bradford, the fact that a company has been financially prudent or managerially prudent in the past and has been able to accumulate some financial capability, strength would influence whether or not the company decides to use the normalization route or a cash flowthrough method?

Mr. BRADFORD. Well, my guess is that most State commissions would hesitate if there were imprudence in any form.

The calculation they would want to make would be whether the particular pace of the refund was likely to increase or decrease the overall rates paid by the customers to that utility. That is, the utility that was financially strapped and had to borrow at high cost to make the refund, would be a less likely candidate for an accelerated refund schedule, not to reward its imprudence. It's simply because the regulators wouldn't want to impose higher costs on the customers of that utility than would occur on a slower refund schedule.

Mr. FLIPPO. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. McGrath.

Mr. McGRATH. Thank you, Mr. Chairman.

I guess we wouldn't be here discussing this today if the tax reform had produced an increase in the corporate rate as some would like.

By the way, Mr. Bradford, these deliberations during the tax reform bill were not haphazard as you have suggested in your written testimony. These provisions were done in subcommittees, and referred to the full committee, where there was plenty of discussion on them. The rationale for section 203, I believe, is the realization that we took tax preferences away from some regulated utilities the 1986 Tax Reform Act.

I'm concerned about whether what you suggest, if it should happen, would result in a significant increase in utility rates to the consumers as a result of the likelihood that many of these utilities would have to go out and borrow heavily in the market, all at the same time perhaps, at high interest rates, which would eventually have to be passed on to the consumer.

I'm also concerned about whether the repeal of section 203(e) would abrogate an arrangement that has been made in New York State between some of the utilities that have entered into agreements to stabilize rates over the next 5 years. I mean we've signed those agreements in contemplation of whatever was in the tax reform bill. Over a 5-year period, the utilities have agreed not to increase their rates based on certain circumstances which they felt were to be continuous.

I'm wondering whether or not you feel that's a problem?

Mr. BRADFORD. I don't feel it's a problem, Mr. McGrath, precisely because if the New York commission had the jurisdiction to deal with the pace of the refund and felt that a rapid flowthrough would be in violation of the terms of any of those agreements, we wouldn't do it.

There's nothing in H.R. 1049 that mandates any pace for the refunds. And to the extent that any of those agreements would be inconsistent with the more rapid refund of these over collections, we would just take that into account.

As to the general point though that you make about utilities having to go out and borrow in order to make the refunds, again I just don't think that's very likely scenario, or at least it's not a likely scenario if it would cost the customers more than the present value of the refunds that would be granted.

Again, regulatory commissions are very sensitive to the need for rate stability. They don't go out and cheerfully lower rates drastically this year only to have to raise them the next year. We've all learned, largely as a result of the changes in fuel prices in the last year or two, that stability is something that customers prize, especially industrial customers.

So I just don't think you'd find regulators, even if you think them to be political animals, I just don't think you'd find them going out and behaving in a way that is politically insensible.

Mr. ABRAMS. Congressman McGrath, if I could add to that.

Mr. McGRATH. Yes, sure.

Mr. ABRAMS. The attorney general's office, together with the Consumer Protection Board, before Mr. Bradford assumed office, worked with members of the Governor's office on some of the

agreements that you referred to. I think you are appropriately focusing on an important issue.

Three points with respect to the agreements.

First of all, the longest agreement in terms of when it comes to an end, is 1990. Many of them are more than midway in terms of the longevity of the pact.

Second, as Commissioner Bradford has indicated, there would be the opportunity for a complete analysis under our proposal by the present Public Service Commission.

And, third, there wouldn't be an element of unfairness or surprise because there is a clause in those agreements which accounts for potential changes in the tax law and gives the commission the right to make an adjustment.

Mr. McGRATH. Wouldn't you feel, Bob, that having signed an agreement like that, you would have to live under the rules that were established by the signing of that agreement?

Mr. ABRAMS. Again, it was contemplated by all sides that by virtue of this clause I just referred to, if there were changes in the tax laws, then the commission could go back and take a look because, in the interim, just as the tax law changed, the economic picture of the utility might well have changed.

And all we're saying is that we're not coming in with a predisposed notion if this bill passed. The authority that would be given utility regulators would be to take a look at the total picture, make individual judgments, utility by utility. I think the direct answer to the point that you're making is that this would be no surprise. The potential for tax law changes was flagged by the parties when they put this kind of clause in the agreements.

Mr. McGRATH. Mr. Chairman, I see that my time has expired. I thank the gentleman.

Chairman RANGEL. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Let me again, if I can, recast this issue just so that we all understand again what we're talking about.

The utility companies have done nothing wrong, and no one should believe they have. At this point, because of the tax rate changes, however, they have \$19 billion of money that they have collected from the customer that should be returned to the customer. The question is how should it be returned.

The 1986 Tax Act contains a little provision that prohibits the State regulators from determining the timing of that return. That's the issue.

Now, I don't begrudge the utility industry at all. If I had \$19 billion of somebody else's money, I'd love to keep it as long as it's humanly possible.

The fact is it has to be returned. With due respect to Mr. McGrath, the provision 203(e) that was put in the 1986 Tax Reform Act was not debated at length. There are many other provisions that were not debated in the Tax Reform Act which you and I now support changing. It was part of a giant package of considerations, most of which we understood, some of which we may not have, and some of which we may now have to correct.

The debate over 203(e) is a discussion about whether this \$19 billion ought to be normalized and the Federal Government tie the

hands of the State regulators or whether the States ought to decide on a case-by-case basis when refunds should be made. I think the State regulators might say to any given number of utilities, you've got lots of cash on hand, and rather than go out and buy a chain of drugstores or an insurance company maybe you ought to consider moving that money back to the customer a little more quickly than 20 or 30 years. That's the issue.

Now, let me, if I may, ask a couple of questions of Mr. Hagen and Mr. Bradford.

The opponents of H.R. 1049—having read their testimony last evening—are going to argue that section 203(e) promotes rate stability, and if we do what Mr. Dorgan says then what we are going to have is short-term lower rates and a long-term increase in rates.

Mr. Bradford, is that true?

Mr. BRADFORD. No, in a word, it's not.

You can't promote rate stability by fixing in the Internal Revenue Code the rate of refund of one particular item of overcollection. You can promote rate stability by giving State commissions the flexibility to determine the pace of the return of that \$19 billion.

That is, for example, if some other item of utility costs, fuel or something else, comes along with a dramatic increase in the next few years, and your rate of return on the overcollection is fixed over the life of the assets, there's no way you can use that money to offset it.

On the other hand, if there is some flexibility, if the State commissions have the flexibility to use the \$19 billion and to refund it at a sensible pace, one of their basic considerations is rate stability. And that's why I'm sure it would be one of the forces that would drive the decisions they would make.

Mr. DORGAN. Mr. Hagen, will the passage of this legislation increase utility rates for the customers?

Mr. HAGEN. I don't think so. I would agree with Commissioner Bradford that State commissions generally are going to, assuming H.R. 1049 would pass, be very careful about how they would actually utilize that in each State.

In North Dakota, we're looking at somewhat over \$50 million. We would take a look at each company. We might do some refunding. We might do some rate adjusting. We might decide that there's certain things that need to be done just to make a company healthier. And I don't think any other commission would be any different.

One thing to remember I think is that State commissions have a pretty tough job. They try very, very hard to be fair. They are not out—assuming this would pass, they're not going to write a check so that each consumer is going to get that the next day. They just won't do that.

Mr. DORGAN. Let me ask a question about diversification and acquisition.

You have perhaps seen the same articles that I've seen in the New York Times, in some periodicals, and the Washington Post suggesting that diversification into other areas is now the new activity of the public utility companies, and I've mentioned some of the acquisitions that we've read about, leasing 747 airplanes,

buying drugstores, insurance companies, savings banks, and the list goes on.

A witness for Edison Electric Institute is going to testify today, and I've read the testimony that it is not true that utilities use excess deferred taxes to pay for diversification in nonutility lines of business.

How would you respond to that, Mr. Bradford?

Mr. BRADFORD. Basically, it is true that you can't trace dollars within a company precisely. But anything that takes the financial pressure off of the utility or, to put it more affirmatively, that gives them access to more capital makes it easier for them to acquire other companies in a diversification context, or to expand in other ways.

It's incidentally a source of funds that I am sure others who will have to compete with them in those unregulated businesses wish that they had access to.

Mr. DORGAN. Is there a regulatory mechanism to prevent utilities from using the cash buildup from this \$19 billion or their portion of it to diversify into other areas? Is there a regulatory mechanism to prevent that?

Mr. BRADFORD. It will vary from State to State, depending on State law.

By and large, major investments in the nonutility areas would require State commission approval or at least the setting up of whatever financial strategy that would allow the utility to go off into those areas would require initial State commission approval.

But that may not be true in all States.

Mr. DORGAN. Let me ask another question.

If someone testifies here today that this legislation is bad for consumers, for reasons that I'm not quite able to understand, is that an accurate statement? Will this legislation require the immediate movement of that money from the utilities to the consumers, or will it give the State regulatory agencies the opportunity to analyze on a case-by-case basis when the money should flow back to customers?

Mr. HAGEN. It gives the State commissions the opportunity to decide what is prudent.

Mr. DORGAN. If a utility company that you regulate does not have a ready source of cash, if the flowthrough would put that utility company in a tough situation, you would not be fulfilling the responsibilities that you have as a regulator in ordering the flowthrough as opposed to normalization.

Would that not be true?

Mr. HAGEN. Yes, I agree with you.

Mr. DORGAN. If another utility is cash flush and is off diversifying into all sorts of things, high flying, forming holding companies, you might look at it a little differently. You might say if you've got so much cash, maybe you ought to consider your customers and the millions of dollars that your customer is owed. Maybe you ought to consider that in the short run. Is that true, Mr. Bradford?

Mr. BRADFORD. That's certainly true. I think you couldn't ask for a more telling moment than the one that occurred this morning when the chairman asked the Treasury Department why no consumer groups were supporting the Treasury position and the utility

position right across the board from industrial customers and residential customers. There is no support for section 203(e). The consumer position is entirely on the other side.

Mr. DORGAN. Mr. Chairman, one final quick question, if I might, of Mr. Abrams, Mr. Barasch.

Do you know of any other instance in which the Federal Government has said to the regulator what we said in 203(e), that is we know that you're a State government body but we're going to tie your hands with this little provision and prevent you from fulfilling your regulatory responsibility?

Is this unprecedented or virtually unprecedented?

Mr. ABRAMS. It is. I know of no other circumstance, and I think, Congressman, it's been pointed out and should be underscored in that context that when the tax law changed several years ago from 48 to 46 percent, there was no outcry from the Treasury Department with respect to that.

Mr. BARASCH. If I could add, the only event that might be comparable is the entire normalization rule itself on Federal taxes where the Treasury Department law and regulation say that if States try to take away the Federal normalized tax benefits, they would lose the benefits themselves.

This section 203(e) would be compounding what is already a problem. Perhaps the line never should have been crossed. But the point question here, to go back to your opening statement, is that this bill has nothing to do with normalization. It has to do with the return of money that, in fact, is properly the property of the residential, commercial, and industrial customers.

If I could make one other comment. There was one other thing that was said here today that I'd like to respond to, and that is the notion that somehow a deal was struck and that utilities were harmed with the loss of ITC and things like that, and that somehow section 203(e) is some sort of compensation for that.

I think what we all have to remember is that ratepayers pay all of the utilities' taxes. So, to the extent the utility companies may have seen some increase in some portion of their tax liability as a result of TRA-86, ratepayers have paid for that too.

So, we are not doing the ratepayers a favor, to also then turn around and take this away from us as well. In fact, the ratepayers have always paid the utility company's tax bill, whatever it may be, and then some. And I think that's really the key point here. It's not really a question of an offset. There have already been other liabilities created, and this just unnecessarily compounds the problem of the residential, commercial, and industrial customers alike.

Chairman RANGEL. Mr. McGrath.

Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

There were a number of fascinating issues raised. I want to address a couple of them to the panel, if I could.

We're in this circumstance for a number of reasons, but one of the major ones, of course, is the rates were changed and we have this deferred reserve.

The panel, if I heard you correctly, has pointed out that that adjustment in rates is something they feel should properly be the

property of the customers of these utilities and the regulated enterprises that are involved.

Let me ask the panel, if rates had gone up instead of down, would you be here advocating that the ratepayers should now pay higher rates?

It's not an academic question. As you know, we do have some people running for President who see that as a solution to our problems.

Mr. BRADFORD. If tax rates had gone up, in my view, that would be an expense that ratepayers would have to carry. I don't think you'd see quite this problem, that is there would be no problem with an overcollected reserve in the event that a tax rate had increased.

The difficulty here is that the utilities are holding money that they will now never have to pay to the Treasury. Just as if we had set the price of oil too high in the fuel clause, and they were holding money that they would never have to pay to their oil supplier. And that money has to go back.

Mr. BROWN. Yes, your analysis is correct. Indeed, they are, because of the adjustment of tax rates, holding money that they may not have to pay.

If I understand the issue correctly though, the decision on whether or not they indeed hold money that they'll never have to pay depends not on the rates today, but on the rates when their particular depreciation schedules turn around and straight line exceeds what's allowed under the accelerated tax system. Is that correct?

Mr. BRADFORD. There are two separate problems. Much the larger one wouldn't fit that categorization. That is, it's a result of money already collected at the 46 percent rate that now clearly will not have to be paid at the 34 percent rate.

There is a smaller problem that was one alluded to on the chart over here—

Mr. BROWN. Let me go back there because maybe I missed my point.

You're assuming the 34 percent rate. But do we know at this moment what the tax rate will be 2 years from now? Are you comfortable it will be 34 percent, because I'm sure not? Are you advocating in effect a return of money based on an assumption of a future tax rate?

Mr. BRADFORD. I'm advocating that customers not pay more than the tax expense that they're really going to face.

We've set rates historically and, in fact, the whole reason these reserves exist is on the assumption the 46-percent rate would persist on into the future.

It seems only fair now that the rate has fallen to assume that the 34 percent rate persist into the future.

Mr. BROWN. Well, I think that the important point here is that you're either advocating that they should receive an adjustment based on the 34 percent rate or you're advocating that they should receive an adjustment based on what the actual tax is at the time that it becomes due.

Mr. BRADFORD. If the Congress were to increase the tax rate next year, then we would clearly have to change utility rates to reflect

whatever the new tax rates were. It would impede the flow back based on the 34 percent paid, and it would affect rates out into the future.

Mr. BROWN. Indeed, your positions then are consistent. I just want you comfortable with the fact that when rates go up, you've advocated that being passed on to the consumers as well. I see that as an essential part of your position.

Mr. BRADFORD. I agree with only this reservation, which is that I do disagree with the overall policy. That is the so-called phantom taxes collected through the years, but that's not, as Congressman Dorgan pointed out, the issue before you today.

Mr. BROWN. You know, I thought that Treasury made an interesting point about the merit or the perceived merit of the system as it's set up. And if I could just briefly summarize it, I think what they're saying is that taking straightline depreciation with regard to regulated utilities had some value in terms of a consistency of ratemaking.

What would your reaction be if we simply went to straightline depreciation for tax purposes?

Mr. BRADFORD. For utilities, I'd be delighted.

Mr. BROWN. Do all of you feel that way?

Mr. HAGEN. It would be fine.

Mr. BROWN. Because that helps the Treasury to some extent as I'm sure you're aware.

Mr. BRADFORD. Let me just add though that the basic principle that underlies my delight is the fact that we could then have tax expenses and ratemaking expenses be the same, so what we were charging customers would be the amount actually being paid.

I think what's happened in the last decade is that the amount charged to customers got so far apart from the taxes actually being paid that we were stuck with a system that we couldn't defend the customers who understood it. It encouraged in some situations utility overinvestment, toward capital intensive and away from energy conservation, away from purchased power, and it's cost us very dearly.

Mr. BROWN. You know, I think that's a valid point.

Let me ask a question. We have some folks who have relied on the current statute, and I suppose you could debate about how many assets that applies to and so on.

How would you deal with the argument that there is some unfair retroactivity in the current bill? Can you adjust for that? Would you want to adjust for it?

Mr. BARASCH. If I could take a shot at that, if you mean during the time period since the passage of TRA-86 to today, I would imagine, first of all, the amount of investment is pretty small.

Second of all, if you take a look at the chart over there with the red area under the curve, if you've been collecting in the early years, you will have run up an excess deferral, if you will. It would probably make up for the difference that you're talking about when we then turn around and change the rules. If you follow me.

There has been a buildup during the early years of the life of the property. At any time prior to the turnaround, if you've been paying in at 46 percent, for example, in order to get back down to zero where nobody wins and nobody loses, you're going to have to

drop that rate considerably below 34 percent in subsequent years in order to end up in the right place.

So there's another pocket, if you will, of excess deferrals that are out there that would be available to absorb this change.

Mr. BROWN. I was thinking only in terms of those people who, since then, had made investments relying on that tax.

Thank you, Mr. Chairman.

Chairman RANGEL. The gentleman from Pennsylvania.

Mr. COYNE. Thank you, Mr. Chairman. Mr. Barasch, it is my understanding that in Pennsylvania certain utilities have already set out a schedule for reimbursement of these funds. Is that your understanding?

Mr. BARASCH. There is two different sets of funds, Mr. Representative. Our office and the Public Utility Commission, I think quite aggressively went about prospectively changing the tax expense of the utilities. In fact statewide in Pennsylvania, the positive impact of TRA-86 was about a \$300-some-odd million reduction in utility bills.

That issue, however, does not take care of the excess deferrals that have built up over time. The new deferrals are still growing because of the turnaround problem on the property that has not yet hit the midpoint. And all the previous balances, what we believe to be about \$800 million statewide, in fact, is sitting there on the utilities' balance sheet, if you will. And that is money that, in a sense, was collected under one set of assumptions and now that money never has to be paid into the Federal Treasury.

That is the issue that we are right now hamstrung from addressing. I cannot legally make the argument that the Public Utility Commission in Pennsylvania should flow back what amounts to a tremendous amount of money, because if they do the utility company will lose the benefits of accelerated depreciation. It is kind of a third rail, if you will. You touch it and you are dead; the benefit is gone.

And that is the second issue. I think the Pennsylvania Public Commission has done a good job on flowing through, if you will, to the ratepayers the great bulk of the benefits that came out of TRA-86. But under section 203(e) they have no power to do anything about the huge volume of prior excess deferred taxes that has built up over time.

Mr. DORGAN. Would the gentleman yield to me?

Mr. COYNE. Sure.

Mr. DORGAN. Let me make the point again that I have seen press reports from various states in which regulatory commissions have made adjustments. None of those adjustments has anything to do with today's discussion of the \$19 billion.

What we are talking about today is not the subject of any action by any utility commission in this country. That \$19 billion exists as excess deferred taxes that have been collected and we are trying to determine whether something should be done to dispose of them differently than would now be required under present law.

Mr. McGRATH. Would the gentleman yield?

Mr. COYNE. I would be happy to yield.

Mr. McGRATH. I am going to have to leave for about an hour or so, and when I come back I expect that this panel probably will not

be here. But I heard Mr. Bradford say that if section 203 were repealed, all other things being equal, there would be no increase in New York state. I just wanted to make sure he said that so that I can go back and tell my constituents that I elicited that response from him today.

Mr. BRADFORD. I do not think I said it, but in fact I would. I do not see how the refund of money could bring about a rate increase as long as it were done sensibly.

Mr. McGRATH. Good.

Mr. BRADFORD. And of course, that is what our commission—

Mr. McGRATH. I am very glad you were so forthright with that. Thank you.

Mr. COYNE. Just to follow up, Mr. Barasch, Mr. Abrams makes the point, and I think justifiably so, that there ought to be a fair and reasonable period of time for the reimbursement based on the utilities' experiences. And I was just wondering if it is your opinion that in this legislation, maybe some special consideration should be given to those utility companies that have made a special effort and have set out a time period already for the flowthrough of the funds?

Mr. BARASCH. The problem is that no utility—to use Pennsylvania as an example, no utility in Pennsylvania has set out any time period for returning this money other than what is required under the average rate method in the Treasury bill. We have a pretty unanimous—not perfect, but pretty unanimous compliance, if you will, on the prospective piece as a result of the PUC's rate determinations in Pennsylvania and also settlements and other things that were done.

The key point here is, if you take a look—and I think the NARUC testimony contains an exhibit that shows that. If you take a look at what happened when the rate went from 48 to 46 percent back in 1978, there was a wide diversity of responses among the various State commissions. Anything from returning the money over 1 year, to returning it over 10 years, to not returning it at all.

And I think what we have got here is just trying to go back to where the world used to be prior to the Tax Reform Act of 1986, which is, it has always been in the correct purview, if you will, of the State commissions to decide how fast that money ought to be returned. And it has always been a hot subject for consumer advocates and attorneys general to make sure that the money comes back as quickly as reasonably possible.

Mr. COYNE. Your understanding is different from mine.

Mr. BARASCH. Not for this pile of money, Representative.

Mr. COYNE. Right. My point is that maybe some special consideration should be given to those who have already established a schedule for the return of the funds.

Mr. BARASCH. I see.

Chairman RANGEL. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman. Mr. Hagen, what kind of repayment schedule would you like to impose in North Dakota if this bill were to pass?

Mr. HAGEN. I think what we would do, assuming this would pass, is we would probably have a generic hearing, have our utilities come in and let them make recommendations, look at the financial

condition of each company and then make a decision based on that. Our companies are pretty healthy. We would probably be looking at some kind of rate adjustments. We might have some refunds.

Our economy is not very good in North Dakota overall because of the agricultural economy. That is a factor. Telephone companies need to do a lot of things. We might decide, maybe you should keep—telephone companies specifically, we might say maybe you should keep most of this and do some things that need to be done, because that is some money that could be used for that purpose in a very good way.

I do not think any utility company is very anxious to give back any of this money necessarily to consumers. But that is why you have a commission to try to work those things out. I do not have a set agenda that it should be flowed through if you go back to 1979, in North Dakota, we let it be normalized.

Would we do that again? We would start from that option and go all the way through the total flowthrough. And I think most commissions would do that very same thing. They do try to be very fair. And I think I speak for all the commissions in the country. We have competent staffs. We work daily with these companies and we try to work out something that just makes good common sense, and keeping those companies healthy. You have to do that.

Mr. ANDREWS. So you are not suggesting an immediate repayment?

Mr. HAGEN. Not necessarily. We would look at it all and decide. If we did decide there should be a refund, would it all be done in one lump sum? No, we would do it over time as would most commissions, I am sure.

Mr. ANDREWS. Do you concur with that, Mr. Barasch?

Mr. BARASCH. As a general proposition, I certainly think that if 203(e) were repealed so that the states had the latitude to consider things, that there would probably be a variety of responses. I imagine the consumer advocate in Pennsylvania would probably be arguing for one result for one particular, and probably a different—

Mr. ANDREWS. What do you think would happen in Pennsylvania? How quickly do you think it would be turned back to the consumers?

Mr. BARASCH. I think it would be a function of the relative financial health of the utilities involved and whether or not—on an issue like this, I think the view of the consumer advocate and the view of the Public Utility Commission is going to be very similar, which is, we also have no interest in seeing utility rates go up as a result of quickly or inappropriately returning these funds.

Back in 1978, that difference was flowed back over 3 to 5 years in Pennsylvania. Whether that would be how this money would be returned, I do not think you could tell.

Mr. ANDREWS. In your opinion, Mr. Hagen and Mr. Barasch, is 12 months too soon? If you had to put a kind of a stink test on this, based on your knowledge, would you say 12 months is too fast?

Mr. HAGEN. I would hate to put a specific time. We might decide it would be less than that, maybe it would be more. Again, you look at individual cases, individual companies. That is why you have a commission. If you were going to make it automatic, you

can just get rid of the commission and just say it is going to be a certain way.

Mr. ANDREWS. Mr. Barasch.

Mr. BARASCH. It would depend. If you had a utility company that was so flush with cash and did not have a better, more reasonable purpose to use that cash for, certainly I would like to see the money returned quicker before they go out to buy drug stores, to use Congressman Dorgan's example.

Mr. ANDREWS. Attorney General Abrams, let me ask you a question to follow up on something Mr. Brown asked the panel earlier and you did not get an opportunity to respond. But in general, if the states are given the power to determine the rate of payment, what happens if in the next Congress or next year the Ways and Means Committee goes back, or the Senate Finance Committee, and increases the corporate tax rates? What in your opinion will the public utility companies do?

Mr. ABRAMS. I think then the commission confronts the issue at that point in time and makes determination for itself.

Mr. ANDREWS. Repeat your answer again, I am sorry.

Mr. ABRAMS. I think each individual commission takes a look at the circumstance and makes decisions as to whether or not there have to be increases based upon that increase in the tax rate by the Congress.

Mr. ANDREWS. Would New York go back in and raise their rates?

Mr. ABRAMS. Again, that is not the function of the attorney general.

Mr. ANDREWS. No, I am asking your opinion.

Mr. ABRAMS. I think you would have a commission that would take a look at all of the circumstances of each company, the health, the merits, the demerits. Again, New York has become a very complicated situation. You have got a company like LILCO that is under enormous stress. And you have got other utilities that are incredibly flush with money. So I think under that set of circumstances, the commission takes a look individually as to what it means to each company.

Mr. ANDREWS. Thank you. Thank you, Mr. Chairman.

Chairman RANGEL. There is going to be a lot of testimony against mandatory passthrough of excess surplus. I assume that none of you are testifying for that. That is not before this committee, but I noticed in reviewing some of the testimony in opposition to the legislation that they concentrate on that.

Is there any reason for industry to be concerned that utility commissioners and attorneys general will be advocating mandatory passthrough?

Mr. HAGEN. Mr. Chairman, I speak for the National Association, that I do not think they should be concerned. That is why you have commissions. And the whole point of this bill would simply assign to the commissions the responsibility to decide, should it be normalized, should it be flowthrough, or should it be something else. And that is, again, done company by company.

Chairman RANGEL. But this panel believes that it is in a better position to determine this on the local and State level than Treasury?

Mr. HAGEN. That is why you have commissions. Congress is a great body, I have tremendous respect for it, but my jurisdiction is within the borders of North Dakota. I have to live there and be there every day. And I think every other commission is the same way, we would try to work it out.

Chairman RANGEL. So if industry was concerned that there would be some mandatory passthrough or some unjust enrichment of consumers during this lifetime, the commission and commissioners and those responsible would be held accountable if you made such a mistake in the future, would it not?

Mr. HAGEN. Yes.

Chairman RANGEL. Is it your responsibility to think in terms of the future investment and capital availability in the long term rather than a short period of time?

Mr. BRADFORD. Absolutely.

Chairman RANGEL. Why would industry not feel secure that you are not going to assume your responsibility and that you would erode prematurely, abruptly destroy the capital in the future, when I think most of you are politically vulnerable if you did that?

Mr. BRADFORD. With all due respect, I do not think that is—although it certainly is reflected in their testimony—a sincere statement of industry's fear. Industry's fear is that they have a better deal under section 203(e) than they would be likely to get from reasonable flowback periods as chosen by state commissions.

H.R. 1049, of course, does not, as you pointed out, by its terms flow a single dollar back. And at the same time, it is unlikely that the State commissions would choose periods of time anything like as long as those that are implicit in 203(e). Industry is upset because it is losing a very good deal for itself in 203(e), not because it fears what State commissions would do.

Chairman RANGEL. But there is accountability to the general public by the commissioners, especially those that are elected; is that not correct?

Mr. HAGEN. Correct.

Mr. ABRAMS. And even those, Congressman, who are not elected. The appointing officer—in the State of New York, it is the Governor, as it is in many other States in the country, is elected. So you have direct accountability by the individual commissioners if they seek office through the electoral process, and if not themselves, by their appointing authority.

Chairman RANGEL. I will be asking more pointed questions of those that would advocate the position that it is in your best interest to have a windfall to go to existing consumers at the expense of the generation to follow. And I think that is the thrust of the opposition to this legislation. And if there are any questions that they might give—I mean, any answers they might give to justify this concern, I would hope this panel would address that.

Mr. BRADFORD. If I might, the windfall is, I am afraid, flowing the other way. The money has already been taken from a past generation of consumers. The difficulty with 203(e) as it stands is that it stretches out the repayment of money that has already been taken from people and businesses.

Chairman RANGEL. I understand the issue, Mr. Bradford. I am saying the testimony is going to say, however, that commissions

and commissioners are going to take the money that has been accumulated and to, without discretion or without concern of the capital needs of the utilities, to pass that immediately to existing consumers.

And my question was, what reason would they have to believe that you would do it? What benefits would a commission get to do this knowing—and I assume it is your job to know—that there will be capital needs in the future of these very same utilities that you have the responsibility to regulate?

Mr. DORGAN. Mr. Chairman, would you yield?

Chairman RANGEL. I would want to see whether or not there is a response and then I would yield to the gentleman.

Mr. HAGEN. I think commissions would want to be, just across the board, very responsible about that. We do not want to have yoyoing rates up and down year to year. We are aware a particular utility may have a very tough problem, and we will take that into consideration. Maybe another one is in better shape. That is just what we do on an everyday basis.

Chairman RANGEL. That is your mandate, is it not?

Mr. HAGEN. That is it, and that is what we do. I think we would work that out.

Chairman RANGEL. Mr. Dorgan.

Mr. DORGAN. Mr. Chairman, I would like to have reflected in the record at this point in the hearing, a letter to our colleague Congressman Matsui from Stanley Hulett, the president of the Public Utilities Commission in the State of California expressing very strong support for this legislation. Mr. Hulett's letter is a lengthy, thoughtful presentation and would fall in line with the presentations of Mr. Bradford and Mr. Hagen.

Chairman RANGEL. Without objection.

[The information of Mr. Dorgan follows:]



ADDRESS ALL COMMUNICATIONS
TO THE COMMISSION
808 VAN NESS AVENUE
SAN FRANCISCO, CALIFORNIA 94108
TELEPHONE: (415) 397-3703

Public Utilities Commission
STATE OF CALIFORNIA

COMMISSIONER

April 3, 1987

The Honorable Robert T. Matsui
United States House of Representatives
231 Cannon House Office Building
Washington, D.C. 20515

Bob
Dear Congressman-Matsui:

Re: H.R. 1049, a Bill Proposing the Utility Ratepayer Refund
Act of 1987

On February 9, 1987 Representative Dorgan introduced H.R. 1049, which proposes to repeal Section 203(e) of the Tax Reform Act. We are informed that you were originally involved in the addition of this section to the Tax Reform Act. We request that you reconsider your earlier position and co-sponsor or support H.R. 1049.

As a result of the Tax Reform Act's change in the maximum corporate income tax rate to 34% as of July 1, 1987, a substantial excess exists in the deferred tax reserves of utility companies. This surplus is due to their collection from ratepayers at the 46% corporate income tax rate for tax liability the utilities have deferred. Since the utilities will now only pay taxes at the maximum rate of 34%, there is no question that they have significantly overcollected amounts from ratepayers for costs that these companies will never have to pay.

We estimate that in California alone, the utility companies have overcollected from the ratepayers more than \$400 million. Thus, only looking at this excess amount of ratepayer-contributed funds in the deferred tax reserves (i.e., the difference between the utilities paying taxes at the 34% instead of the 46% rate), we estimate that Southern California Edison Company has overcollected more than \$160 million from its ratepayers, that

Pacific Gas and Electric Company and Pacific Bell have each overcollected more than \$80 million from their ratepayers, that San Diego Gas and Electric Company has overcollected more than \$45 million from its ratepayers, and that other utility companies in California have likewise overcollected large sums from their ratepayers.

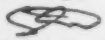
Congress recognized that this change in the corporate income tax rate would result in a huge windfall to utility companies in this regard. However, in Section 203(e) of the Tax Reform Act, Congress dictated that this excess must be refunded to the ratepayers over the remaining regulatory lives of the property giving rise to these deferred tax reserves. What this means is that the ratepayers will receive the refund of their money on a piecemeal basis over a long period of time, which in some cases may be as long as 30 years.

Since there is no dispute that the overcollection of money (in view of the change in the tax rates) will ultimately be returned to the ratepayers, we are at a loss as to why Section 203(e) of the Tax Reform Act precludes state regulatory commissions, such as the Public Utilities Commission of the State of California, from utilizing more expeditious refund mechanisms. Indeed, since people and businesses move, people die, and some businesses terminate, there is a much greater likelihood of returning these sums to the ratepayers who actually overpaid them if the utility companies are required to expeditiously refund the excess in their deferred tax reserves.

To the extent that any particular utility company faces an undue hardship caused by a requirement to promptly refund large amounts to ratepayers, that is an issue that can be considered by the relevant state regulatory commissions, which, after all, often balance the needs of utility companies with the interests of ratepayers while taking into account all of the equities in a given proceeding.

We therefore believe that H.R. 1049's proposal to simply repeal Section 203(e) of the Tax Reform Act (as if it had never been enacted) is totally warranted. We urge you to co-sponsor this bill and to take an active role in ensuring that it is passed by the House Ways and Means Committee, and eventually the full House of Representatives.

Sincerely,



STANLEY W. HULETT-
President

Chairman RANGEL. Let me thank the panel for their testimony. The record will remain open in case there are any answers or additional testimony that you may want to give. And if there is no objection from the committee, that would apply to the panels that will follow you. Thank you very much.

The next panel is Richard Sadler, representing the Alliance for Fair Competition; Edwin Rothschild, representing the Citizen Action; Mark Cooper, director of research, Consumer Federal of America; Environmental Action, Ruth Caplan, executive director; and Gareth Kajender, chairman of the Illinois Industrial Utilities Consumers.

Those that are leaving, please exit as quietly and swiftly as possible so that we can resume taking testimony.

The panel is aware of the 5-minute rule, which will allow you to put your entire statement into the record, and you can proceed in any manner that you would like. The Chair recognizes Richard Sadler.

STATEMENT OF RICHARD L. SADLER, ESQ., COPELAND, LANDYE, BENNETT & WOLF, ON BEHALF OF ALLIANCE FOR FAIR COMPETITION

Mr. SADLER. Thank you, Mr. Chairman and members of the committee. My name is Richard Sadler, I am an attorney in private practice from Portland, OR. I have previously submitted to the committee a much longer statement along with some exhibits which I would like to offer at this time. My comments, necessarily, will be as brief as I can and I would like to proceed.

My experience in this is that about 2 years ago I became heavily involved in behalf of various groups, as set forth in the written testimony, involved in a very complex affiliate interest transaction in the State of Oregon involving Pacificorp, doing business as Pacific Power & Light. Out of that experience, I think I gained a general working knowledge of some of the issues of diversification and affiliate interest transactions which are relevant to these proceedings.

At the outset I would like to make one comment concerning these remarks. The issue as to whether or not the utilities can and under what circumstance utilize this some \$15 to \$19 billion kitty of money to finance diversification issues is a very complex one. It will vary from State to State. It will vary from utility organization to utility organization.

Let me just briefly state that I do not think it is possible for anyone to state categorically that a utility will or will not in any given circumstance be able to do that.

I think it is fair to say, however, that one way or another, directly or indirectly, capital infusion that comes from this kitty of money that will never have to be paid to the Treasury certainly enhances the capital structure of any utility. And to that extent it is almost, without question, that it aids that utility in its diversification efforts, whether that is direct or indirect aid.

Now the next thing I would like to comment upon is, the purpose of these comments are really to go to the point that I think has not received nearly enough attention in the regulatory community, and indeed, in front of the Congress. And that is, it is generally assert-

ed that this diversification effort is without risk to the utility structure, provides a better and substantial financial basis for the utilities to operate.

My comments are directed to what I believe are the grave risks of what is happening in this massive diversification effort. And to the extent, therefore, that these funds further fuel that diversification, I think that—and from my opinion, it is unwise public policy.

Now at the outset let me make a distinction that I think is critical. General diversification efforts mean diversification into wholly different activities. That the utility does not intend to, therefore, do business with itself; jet airlines, silver mines, drug stores, such activities are in that category.

There is another area that I think is equally if not more important to look at. And that is what I would like to call affiliate interest diversification. That situation is where the utility has created a wholly owned subsidiary, at least in part, to do business with itself.

Now let me very briefly indicate some of the risks I see in both forms of diversification. By definition, Mr. Chairman, members of the committee, this is a subject which one could expound upon for a great deal of time. So what I am suggesting today is certainly the briefest possible explanation of it.

The first thing I would like to point out is, is that to the extent utility diversification is unsuccessful, I believe it poses a grave risk to the utility structure. The whole premise of utility diversification is that the money being spent on the diversified activities will be wisely invested.

As Mr. Frisbee of Pacific Power & Light himself has indicated in an article in Forbes magazine, 1986, which is attached to my comments, there is the gravest risk that the utility who is, in fact, a consumer and service oriented group, the executives of those groups will not, in fact, wisely invest these funds in diversified activities. And Mr. Frisbee himself has the gravest doubt that across the country these funds will be, in fact, wisely invested.

Now to the extent that they are not wisely invested, it creates a number of difficulties. The most substantial of which is that unless the company and the regulators involved maintain the utmost diligence, the utility assets themselves can be put at risk. Now that is a complicated problem and depends upon whether the company is operating under the Public Utility Holding Act of 1935, whether it is not. But I believe that in many circumstances, the assets of the public utility itself can be put at great risk.

The second point that I would like to make regarding the general diversification is that under general diversification there is a fractionalization of the company, between those managers inside the company that are interested in earning a profit from outside activities, and those members of the company who are committed to a utility and service oriented structure.

I believe that the breaking apart of this focus that has traditionally been the case in the utility industry is in the end going to be very damaging. And that the risk exists of the utility part becoming second-class citizens.

The last point I would make is, affiliate interest transactions, as I discovered in the case that I was personally involved with, are so complex and difficult that I believe that one of the risks that the

companies pose to the regulatory process is if affiliate transactions are not closely scrutinized, indeed not prevented except in the most extreme circumstances, that the complexities that arise from the company doing business with its unregulated affiliates will be such that it will not be possible to adequate the companies into the future.

Thank you.

[The statement of Mr. Sadler follows:]

TESTIMONY OF RICHARD L. SADLER

Mr. Chairman and Members of the Subcommittee, I would like at the outset to thank the Subcommittee for an opportunity to provide these comments.

As a preliminary matter, my involvement with utility industry issues may be less obvious than many of the other witnesses who have testified before this Subcommittee. Therefore, I feel it might be helpful to provide the Subcommittee with a brief explanation of how I came to be involved in utility regulation and the diversification and affiliate interest issues which are related to the proposed legislation now under consideration. I am an attorney in private practice in Portland, Oregon, and have practiced in Oregon for approximately 13 years. During that time, a principal focus of my practice has been administrative law, and more particularly, transportation and utility regulation before the Oregon Public Utility Commission ("Oregon PUC") and the Washington Utilities and Transportation Commission ("WUTC").

In early 1985, Oregon's largest privately-held utility, Pacific Power & Light ("PP&L") filed an application under Oregon's affiliate interest regulations to establish an affiliated subsidiary to enter the electrical distribution business. I was requested by a coalition of local electrical distributors and the National Association of Electrical Distributors to represent them in challenging this proposed affiliate operation. These parties were concerned that WDSI's ability to subsidize its operations would create an unfair competitive advantage over the general electrical distribution industry. This challenge took over a year in its prosecution and resulted in hearings before the Oregon PUC and my intervention in rate proceedings before the WUTC. As a result of these protests and the testimony received at the Oregon hearing, PP&L withdrew its application for its wholly-owned subsidiary known as Western Distribution Service, Inc. ("WDSI"). After withdrawal of the Oregon application, the WUTC issued a stringent request for information regarding the subsidiary's activities. Shortly after this request for additional information, PP&L unilaterally decided to close down all of WDSI's operations, and to my knowledge, the WDSI activities have now been completely terminated.

Opposing PP&L's affiliate application necessarily required a thorough examination of the full range of issues regarding utility diversification, particularly as it affects affiliated diversified companies. Since that time, I have attempted to remain generally familiar with the broad policy questions regarding utility diversification and affiliate interest transactions, but I should emphasize that my principal first-hand experience in this area was a direct result of the extended efforts undertaken regarding PP&L's proposed WDSI operation. As the issues involved in the WDSI case are somewhat complex and the historical background difficult to summarize, I have provided as additional exhibits to this written testimony various newspaper articles and other materials concerning this transaction for the Subcommittee's review. I would like to call particular attention to the article which appeared in the May, 1986 of The Electrical Distributor. It provides a good overview of the PP&L proposal and its subsequent demise.

Since the issues before this Subcommittee under H.R.1049 are necessarily of broader scope than those in the WDSI case, I will not attempt in these comments to outline the specifics of that transaction. I would, however, be happy to discuss that case further if members of the Subcommittee feel that would be helpful. The WDSI case certainly is a prime example of the general problems associated with affiliate interest transactions.

I would like at this time to provide a short discussion of the scope and direction of this testimony. I should emphasize that I am not a tax attorney nor is my practice directly related to tax issues. Therefore, my testimony in these proceedings will relate to the broader issues of diversification and affiliate interest transactions involving privately-held utilities, and not on the specific and detailed tax issues which are necessarily raised by the proposed legislation in H.R.1049. I believe I am generally familiar with the tax provisions and their ultimate effect, but I am not in a position to testify about them as a tax expert.

My testimony, therefore, will be limited to a policy discussion of the problems associated with utilities' growing interest in diversification and affiliate interest transactions. Since H.R.1049 does not directly address these broad regulatory concerns, the obvious question is, "Why should we be discussing diversification and affiliate interest transactions in the context of the current proposed legislation?"

A fair answer to this question necessarily requires an understanding of the underlying concepts involved in deferred tax reserves and what use utilities have made of these tax windfalls in the past. I think it is fair to say that in its simplest terms, the tax structure and the "normalization" process within the tax structure has allowed utilities to collect substantial revenues from the ratepayers based on projected tax payments which in fact the utilities have not been required to pay currently, due to favorable depreciation, investment tax credits and other tax provisions. The net effect of these various tax provisions has been to create a substantial fund of money immediately available to the utilities for current purposes with little or no debt service associated with these funds. Although it is my understanding that the specific procedures vary somewhat from utility to utility and from state to state, generally speaking, although these excess deferred tax funds are booked as a separate accounting entry, they are nonetheless available to the utility for investment purposes, investment purposes not necessarily restricted to investments in utility operations.

As a result, those utilities involved in diversification and affiliate interest transactions have often used these deferred tax reserves to finance their diversified companies. Under the previous tax structure, most of these funds would have been repaid to the Internal Revenue Service, albeit over an extended period of time. As a result of the provisions of the 1986 Tax Reform Act, and more particularly the general decrease in corporate tax rates, some of these deferred taxes will now not have to be repaid at all. It can be expected that a substantial percentage of these unpaid deferred tax reserves will be used for diversification and affiliate interest transactions if they are not returned to the ratepayers. Therefore, the wisdom of these diversification efforts becomes, as a policy matter, directly related to any ultimate determination as to whether these funds should be available to the utilities for an extended period for their own purposes. I personally believe these funds are properly ratepayer monies and should be immediately returned regardless of what use the utilities plan to make of them. However, it is my expectation that other witnesses will have dealt in more detail with this particular question of equity, and therefore, I will concentrate on discussing the substantial risks to the ratepayers and the overall regulatory process, which I believe will result from any encouragement to private utilities to intensify their diversification and affiliate interest transactions.

At the outset, it is important to draw a firm distinction between two quite different forms of diversification activities undertaken by private utilities. Although both distinct forms of diversification create, in my opinion, substantial difficulties

for the ratepayer and the regulatory process, the nature of these difficulties can be substantially different. To my knowledge, there are no generally accepted rhetorical labels for these two forms of diversification. Therefore, let me suggest for the purposes of this testimony the following terms. "General diversification" refers to the diversification of a private utility into companies that are wholly-unrelated to the utility's primary activities and will not conduct any business with the utility. On the other hand, "affiliate interest diversification" refers to the formation or acquisition of subsidiary companies by the utility which are in some respect directly related to the utility's principal activities and can be expected to do business with the utility. By way of example, a utility company's creation of a wholly-owned subsidiary for the purpose of purchasing jet airplanes to lease to foreign airlines would be a general diversification activity. On the other hand, using the Oregon WDSI example, an effort by the utility to spin-off its entire purchasing department into a wholly-owned unregulated subsidiary corporation whose purpose is to sell utility products both to the utility and to third parties is a classic example of affiliate interest diversification. As indicated, the difficulties to the ratepayer and the regulatory process from these two similar but quite distinct forms of diversification are markedly different.

First, I would like to take a look at the issues relating to general diversification. Although utilities have for decades been involved in a relatively minor way in non-utility business ventures, the current operational and financial realities in the utility business have made this issue more critical in recent years. Until the early 1970's, and the onset of the oil crisis and its painful lesson that energy supplies must be carefully protected, energy-related utilities generally emphasized internal growth. As a result, most if not all of the capital generated by the utility operations could be profitably invested in the utility's own operations. The utility would attempt to increase consumption of the energy it provided, and since the regulatory process provided a handsome return on all of these investments, little incentive existed for these energy utilities to seriously pursue other business ventures. This, of course, was an era highlighted by energy companies explicitly advertising and creating a demand for ever more consumption of energy.

The oil crisis, which created an interest in conservation, coupled with the general economic slow-down, sharply cut back growth in the energy utility industry. Since the utilities are virtually guaranteed a profit by the structure of the regulatory process, they had to find some plan to invest these profits. In the telecommunications area, technological change and the divestiture of the AT&T system have lead to similar pressures on the part of the telecommunications industry to invest ever greater sums in its diversified non-utility operations. Thus, all utilities have, in recent years, been under intense pressure to find new ways to invest profits from their utility operations in non-utility business ventures. This has lead to a virtual explosion in the diversification of major utilities. There is nothing on the immediate horizon which would suggest that this pressure is likely to subside in the near future. In this regard, Oregon's local example of Pacificorp is a classic example of a utility that has become highly diversified. According to Mr. Don Frisbee, the Chairman of Pacificorp (doing business in part as PP&L) only 64 percent of Pacificorp's \$245 million in profit for 1986 was related to its utility operations. The remainder was a result of the Company's diversified activities. Because of this substantial diversification effort, Pacificorp's stock is no longer traded as a utility.

The policy issue relevant to these proceedings is whether or not these massive diversification efforts should be further encouraged by preferential tax treatment, which has the effect of

providing the utilities with even more funds to diversify into non-utility holdings. I do not believe Federal tax provisions should further finance these efforts.

Although the issues underlying the wisdom of utility diversification are complex and vary from one corporate structure to the next, I believe there are two fundamental reasons why this diversification is not in the long-term best interest of ratepayers or the regulatory process. The first of these reasons is financial. The second relates to the management and focus of the utility industry itself.

Financially, utilities have argued that diversification has strengthened the base of utility organizations and provided their shareholders and ratepayers with more stable corporate structure to continue their utility operations. By definition, this position is only true if the utilities' wisely invest their excess cash in non-utility ventures. There are numerous reasons to believe that this is not in fact going to be the long-term outcome of these investment alternatives. Aside from the general business risks that surround any investment in new enterprises, none of which are immune from major or cataclysmic downturns unpredicted by corporate executives, the utilities are particularly susceptible to bad investment strategies, given their service oriented, non-competitive history. It is no secret that the business world in the late 1980's is a tough, indeed ruthless environment. It is an environment not easily understood or mastered by managers who have traditionally run service-oriented corporations, whose profits, for all intents and purposes, are guaranteed by the regulatory process. The cold, hard truth of the matter is that utility executives are seldom been called upon to exercise the same level of entrepreneurial judgment as companies competing in the marketplace. To place in the hands of such management vast sums of money for investment in diversification non-utility structures is a blueprint for long-term disaster. It is interesting that Mr. Frisbee, one of the most knowledgeable utility executives involved in diversified activities, seems to agree with this general position. In a candid interview in the June 16, 1986 edition of *Forbes* magazine (a copy of which is attached), Mr. Frisbee himself outlined several of the factors that led him to conclude that "cash-driven diversification isn't likely to turn out very well". Indeed, Pacificorp's own diversification has been, according to *Forbes*, "something less than an unmitigated triumph". As set forth in the *Forbes* article, Pacificorp's electric business is now more profitable than its diversified activities. In summary, when asked if the utility industry's current diversification was likely to be successful, Mr. Frisbee's answer was, "Not very."

What then are the long-term financial consequences if the utility industry's diversification efforts are financially unsuccessful. This becomes an even more important question when utilities, to avoid the consequences of the Public Utility Holding Company Act of 1935 and various state regulatory issues, have not completely separated their utility operations from their other diversified activities. If these utilities' diversification efforts are not financially successful, the long-term result must weaken the utility structure unless regulators are able to artificially insulate the utility structure and the ratepayers from these business failures. I am personally doubtful that this insulation can be fully effective. At the present time, most utilities are not permitted to directly encumber the utilities' assets for non-utility ventures. However, many utilities have a corporate structure that could subject the utilities' assets to the claims of general creditors. In the most extreme case, a utility company, which was forced into bankruptcy as a result of diversified business failures, might not be able to assure the regulatory process that creditors of the diversified activities would not have rights to utility property. It is my general understanding that regulators and the utilities themselves have

made substantial efforts to insulate themselves from this possibility, but it is not clear at this point that such insulation has or will be completely effective if challenged in a bankruptcy proceeding. Thus, in the most extreme case, a company's actual utility operations could be put into direct jeopardy as a result of its diversified activities.

A more likely scenario, however, is that the indirect financial problems created by diversified activities, which are not catastrophically unprofitable, would nonetheless require continuous sources of revenue from the utility structure to finance the diversified operations. Although most regulatory processes require the utilities to seek prior approval for any long-term borrowing, unless the regulatory process is exceedingly diligent, a utility whose diversified activities are failing could easily over-leverage its utility operations to raise the cash necessary to keep the diversified activities alive. Given the complex nature of rate calculation, such an over-leveraging would almost certainly have the effect of raising the companies' costs of funds, which, under the regulatory process, would have the direct effect of increasing costs to ratepayers.

Another direct financial result of a company's diversification efforts is to vastly complicate the analysis of the equity portion of the cost of funds analysis that utilities always undergo as a part of the ratemaking process. Although the details of the ratemaking process are complex, and I am not fully versed in all of its details, one principal aspect in determining the utilities' ultimate rates is a cost-of-funds calculation. In this process, various expert witnesses attempt to determine what rate of return the company needs to make to attract equity capital into the corporation. Given the virtually guaranteed profitability of most utilities, at least prior to various nuclear fiascos, and the traditionally high dividend rates utilities paid on their common stock, this calculation, though complex, was at least somewhat manageable. Where a company has fully diversified its activities and its stock is in fact no longer considered a utility stock by the investing public, this equity portion of the cost of funds calculation becomes extremely difficult, if not totally impossible, to determine.

It has never been clear to me why the ratepayers should be responsible, even indirectly, for the success or failure of a utility's diversified activities. The ratepayers and the regulatory process in general has virtually nothing to say about whether the company should or shouldn't diversify in the first place and certainly has little if anything to say about which individual investments the company should make. Nonetheless, as the above examples illustrate, the ratepayers and the regulatory process in general necessarily are put at some risk as a result of these diversified activities. The ratepayers, therefore, have become, in effect, limited partners in the utility's diversification efforts, whether they want to be or not. I do not personally believe these financial risks are risks to which the ratepayers should be subjected and believe that sound long-term utility management should specifically require a clear and distinct legal and practical separation between a utility's diversified activities and its utility operations.

Perhaps an even more damaging aspect of diversification to the management of private utilities is the necessary lack of corporate attention which will ultimately be paid to the company's utility operations given the drama and excitement of the new diversified business ventures. Running a stable, on-going utility is not, under normal circumstances, as exciting or demanding, from an entrepreneurial point of view, as starting up or investing in new business ventures. Utility companies are, at their core, service entities which, in the best of times, have difficulty attracting the highest level of energetic entrepreneurs. Even Mr. Frisbee himself conceded this point when

he stated in the 1986 *Forbes* article that he viewed Pacificorp's diversification as a way to break the "conservative, superior, almost bureaucratic mindset that affects many utility managements. 'It has given a real lift to the organization,' Frisbee says, 'and enabled us to develop a more risk-taking attitude.'" The difficulty from the utility's standpoint is that bright and capable managers within the utility structure will necessarily see the diversified activities as more glamorous and exciting than the service-oriented utility business and will seek opportunities to transfer within the company to the diversified activities. The same phenomenon will tend to occur with new hiring within the company itself. It is natural to assume that a new, bright, capable entrepreneur would much prefer to be in an unregulated business environment where his growth opportunities and compensation are virtually unlimited than in the fairly structured and restrictive environment of a private utility. Thus, a kind of brain drain can develop when a company's diversified activities take on an ever-increasing prominence in the company's overall operations.

A diversification effort, if undertaken on a substantial basis, can lead to a lack of focus within the corporate structure and a breakdown in the service orientation of the utility's operations. There can easily develop within the corporate structure of the parent company a conflict between what is in the interest of the utility operations and the diversified business opportunities. Even though capital and human resources within most utility companies are substantial, there is never an unlimited supply of money or talented people, and allocations of manpower and resources between diversified activities and utility operations could easily lead to a position where the overall corporation structure is less and less focused on, and concerned with, the company's direct utility operations. Since this diversification effort is a relatively new phenomena with only a few utility companies fully diversified, the full effects of this potential problem are yet to be seen. Given my involvement in the Northwest, however, I am convinced that the long-term effect of these diversification efforts will in most cases be damaging to the level of service provided by the company's utility operations.

These comments, of course, have not fully covered all of the ramifications of general diversification. However, I do believe they substantiate the general premise that diversification is at best a very mixed blessing, and at worst, poses a grave risk to the ratepayers and to the regulatory process in general.

Finally, I would like to address briefly some of the issues relating to affiliate interest transactions. In this area, the utility not only creates an unregulated, diversified company within its overall corporate structure, but intends for that company to do business with the utility itself. This is of course precisely the situation in the PP&L case in which I was involved in 1985 and 1986. Here the dangers to the ratepayer and the regulatory structure are much more immediate and direct than those encountered in general diversification. Although the area of affiliate interest diversification is complex in its individual circumstances, the general structure of such transactions creates two very prominent direct threats to the ratepayer and the regulatory process. The first of these threats is the very real and, in my opinion, virtually certain existence of cross-subsidization by ratepayers of the affiliate's transactions. The second is my belief that wide-spread affiliate interest transactions will render the entire regulatory process virtually meaningless.

Let me first turn to the cross-subsidization issue. In an affiliate transaction, the parent utility intends to either provide services to the newly-created and unregulated affiliate or to receive goods and services from that affiliate. In the

WDSI case in Oregon, both sides of this equation were to take place in that PP&L was to provide certain accounting, engineering and other support services to WDSI and, in turn, WDSI was to sell goods and some services to PP&L. In such a situation, cross-subsidization will occur at any point the parent company provides services to the unregulated affiliate at less than full and complete cost to the utility or where the affiliate provides goods and services to the utility at greater than the actual fair market cost of such goods and services had they been provided to the utility by independent third parties. If either of these situations occur, by definition, the ratepayers will have cross-subsidized the unregulated activities of the affiliate. In simple terms, the ratepayers will have, through this structure, given money to the shareholders of the private utility.

No one, to my knowledge, including the utilities, has ever argued that such a cross-subsidization is proper. The utility's argument is that such cross-subsidization can be effectively monitored and controlled by proper accounting for and allocation of the costs of goods and services so that ratepayers are not damaged. After 18 months of protracted litigation and detailed settlement negotiations, I have reached the conclusion that it is impossible as a practical matter to prevent such cross-subsidization from occurring. The virtually unlimited number of accounting and allocation decisions which have to be made in any substantial affiliated transaction are so complex and numerous that I do not believe that any corporate structure can effectively monitor or control them. I believe this to be the case whether the utility is consciously undertaking an improper program of cross-subsidization or whether it is simply an inadvertent result of the failure of the utility's accounting systems to completely and adequately deal with the issues involved.

It would be impossible in the time allowed in these hearings to review even briefly the detailed issues of cross-subsidization which arose in the relatively simple WDSI case. However, a few examples might be useful. In this case, the principal problem was assuring that the costs of the goods provided by WDSI to the utility were in fact at fair market value. As is obvious to anyone who has studied controlled economies, virtually any artificial system used to determine fair market value is, at the outset, hopelessly flawed. Testimony was provided in the hearings that the actual fair market value of individual utility products varies on a day-to-day and hour-to-hour basis, depending on a whole range of economic and competitive factors which are impossible to artificially duplicate. Therefore, it became obvious in the course of these proceedings that the regulatory process was essentially depending upon the utility's assertion that the wholly-owned affiliate would not charge "unreasonable" prices.

An identical and equally complex problem exists in attempting to price the services the utility is providing the affiliate. For example, when the affiliate in the WDSI case requested engineering services from its parent, the Company had to determine what was the fair charge to make for these engineering services. At the outset, it was necessary to guarantee that all informal requests for such engineering services would in fact be recorded. Typically, engineers in large utility companies are not required to keep detailed daily timesheets. Therefore, it is unrealistic to presume that this onerous process would be rigidly adhered to in every case by the engineers involved. Even if the time was properly recorded, it becomes virtually impossible to set a precise and fair rate for the engineer's time. Should that rate be based on equivalent outside consulting rates for services or should it be based on some internal calculation of the actual cost to the utility for providing the services? If it is to be an internal costs mechanism, what factors go into that cost allocation system? Are

the engineer's overhead, office and secretary to be included? Is the photocopier shared by the general engineering department to be allocated? What about the engineer's training, which is undertaken at the expense of the utility? All of these accounting problems must necessarily be resolved fairly to prevent any cross-subsidization from occurring. An accounting must be done for every transaction between the affiliate and the parent if cross-subsidization is to be eliminated. Again, I hope this somewhat detailed and specific example will demonstrate the practical impossibility of assuring that all of these accounting allocations can be completely and fairly resolved.

In this context, the regulatory community must be constantly aware that aside from sanctions imposed by the regulatory process, there is absolutely no financial incentive for a utility to prevent this cross-subsidization from occurring. Since utility rates are, as a practical matter, set to guarantee the utility an adequate return on its investment, the utility and its shareholders will directly benefit from any cross-subsidization unless they are discovered in the regulatory review process and the utility is effectively sanctioned in the ratemaking process.

This leads to what I believe to be the most dangerous aspect of affiliate interest transactions. It is an open secret that the regulatory process is already taxed, if not overtaxed, to keep up with the increased complexity of a public utility's operations. Utilities can afford to hire the best possible legal and accounting talent to structure their requests for rate relief in the most favorable possible light. Given the limitations of the regulatory system, most major rate requests, even under the present system, cannot receive the kind of careful and detailed scrutiny that most regulators would prefer. Instead, the regulatory community is most often forced to limit its review to the major big-ticket items in any rate request. This is not to suggest that the regulatory process has broken down, but only that it is severely taxed to keep up with the duties with which it is legally charged. I sincerely believe that asking the regulatory community to fully review and evaluate yet another layer of financial transactions regarding affiliate companies is unrealistic and foolhardy. Unless this trend to create affiliates is checked, there is nothing to prevent private utilities from spinning off virtually all of their current operational groups into wholly-owned affiliates. In the WDSI transaction, we saw a proposal to spin off the entire PP&L purchasing department into a wholly-owned affiliate electrical distributor. The Company has already spun-off virtually all of its coal reserves to its wholly-owned subsidiary known as NERCO. There would be nothing in the future to prevent the Company from taking similar action with its engineering department, line construction crews, the leasing and ownership of vehicles, computer services system, and virtually any other independent division of the Utility's operations. It is entirely possible that under such a structure a future utility will actually control little, if any, of its actual utility operations. Instead, it will operate as a massive contractor which lets subcontracts to its myriad wholly-owned subsidiary affiliates in order to provide utility service to the public. It is not difficult to understand that the complexity of such an entity would be beyond the reach of the current regulatory process. Attempting to audit and review the hundreds of thousands of transactions between the utility and its wholly-owned affiliate subsidiaries would be beyond the scope of any regulatory commissions with which I am familiar. Thus, the very real possibility exists that the wholesale formation of affiliate subsidiaries could lead to a substantial breakdown in the regulatory process itself.

In conclusion, therefore, I believe that diversification and affiliate interest efforts of modern, privately-held utilities are not in the long-term interest of the ratepayer or the regulatory process, and that these activities should not be

encouraged by allowing utilities to keep monies which should be rightfully returned to the ratepayers.

Before I close, I would like to point out that I do not mean to suggest that in every circumstance, such activities would be unwise or improper or that in certain circumstances, some benefits could not be derived from such activities. Nothing as complex as utility diversification is subject to such simplistic evaluations. However, I do believe that on balance, ratepayers and the regulatory process will not be well-served by these activities and that it is not sound policy for the Federal tax system to further encourage these diversification efforts.

I want to thank you for this opportunity to provide these comments and would welcome any questions that you might have on how diversification may affect the future of the regulatory process.

OREGON REVISED STATUTES

UTILITY REGULATION GENERALLY

757.495

757.495 Contracts involving utilities and persons with affiliated interests. (1)

No public utility doing business in this state shall make or contract to make any payment, directly or indirectly, to any person or corporation having an affiliated interest, for service, advice, auditing, accounting, sponsoring, engineering, managing, operating, financing, legal or other services, or enter any charges therefor on its books, which shall be recognized as an operating expense or capital expenditure in any rate valuation or any other hearing or proceeding, until the propriety and reasonableness of any such payment, or contract for payment, has been submitted to and approved by the commissioner.

(2) No public utility doing business in this state shall enter into any contract, oral or written, with any person or corporation having an affiliated interest relating to the construction, operation, maintenance, leasing or use of the property of such public utility in Oregon, or the purchase of property, materials or supplies, which shall be recognized as the basis of an operating expense or capital expenditure in any rate valuation or any other hearing or proceeding, unless and until such proposed contract has been submitted to and approved by the commissioner.

(3) When any such proposed contract has been submitted to the commissioner, the commissioner promptly shall examine and investigate it. If, after such investigation, the commissioner determines that it is fair and reasonable and not contrary to the public interest, the commissioner shall enter findings and order to this effect and serve a copy thereof upon the public utility, whereupon the contract may lawfully be recognized for the purposes entered into. If, after such investigation, the commissioner determines that the contract is not fair and reasonable in all its terms and is contrary to the public interest, the commissioner shall enter findings and order accordingly and serve a copy thereof upon the public utility, and it shall be unlawful to recognize the contract for the purposes specified in this section.

(4) No public utility shall issue notes or loan its funds or give credit on its books or otherwise to any person or corporation having an affiliated interest, either directly or indirectly, without the approval of the commissioner.

(5) The action of the commissioner with respect to all the matters described in this section when submitted to the commissioner, shall be by findings and order to be entered within 90 days after the matter has been submitted to the commissioner for consideration, and the findings and order of the commissioner with respect to any of such matters shall be and remain in full force and effect, unless and until set aside by suit brought and prosecuted, as provided in ORS 756.580 to 756.610, and the public utility, or any other person or corporation affected by any such findings and order, may bring and prosecute such suit. [Formerly 757.170]

ARTICLE FROM

THE BUSINESS JOURNAL

WEEK OF DECEMBER 23, 1985

VOLUME 2, NUMBER 43

PacifiCorp, state clash over spinoff

Fate of utility's proposal will set regulatory precedent

By JOHN M. VILLAUME

Things haven't worked out the way PacifiCorp had planned.

The utility's proposal to transfer assets and functions from one branch of the PacifiCorp family tree to another has been stalled in the office of the Oregon Public Utility Commissioner (PUC) for the last year. Observers see Pacific Power's application to the PUC as a test case that may determine the future of affiliated utility spinoffs—at least in Oregon.

PacifiCorp, an already-diversified utility with \$5 billion in assets, has had trouble spinning off about \$5 million in assets from Pacific Power's materials and supplies divisions to Western Distribution Service Inc., a wholly owned PacifiCorp

subsidiary. And after nearly a year Western Distribution has yet to obtain PUC approval to manage its parent's material inventories and sell it electrical supplies.

Pacific Power is the business name under which PacifiCorp conducts its electrical utility operations.

Plans approved by PacifiCorp's policy group in early 1984 have encountered stiff opposition from PUC staff members and fierce resistance from electrical supply companies and the National Association of Electrical Distributors.

As originally envisioned in 1983, Pacific Power intended to capitalize on in-house expertise to establish a subsidiary, Western Distribution Services Inc. That subsidiary would be formed from the assets, per-

sonnel and technical capability of Pacific Power's own materials management group. That group purchased and distributed Pacific Power's line construction and maintenance materials out of headquarters in Wilsonville, Ore., and Casper, Wyo.

In the original plan, Western Distribution would procure, store, deliver and provide other material management services to Pacific Power under contract. But Western Distribution also would attempt in five years to capture approximately 10 percent of what Pacific Power's April 1984 business plan estimated to be a \$350 million regional market for such services.

That market largely coincided with

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Agency argues PacifiCorp plan may raise ratepayer costs

Continued from page 1

Pacific Power's service area—Washington, Oregon, Wyoming, northern California, Idaho and Montana. Pacific Power's business plan also envisioned expansion into Utah.

The market was composed of utility construction contractors, industrial customers, and over 130 utilities with the same basic material needs as Pacific Power.

Pacific Power expected Western Distribution the first year would have sales of up to \$14 million and could grow to \$30 million over a five-year period, earning a 20 percent return, company documents reveal.

Central to Pacific Power's plan was acquisition of "an existing, successful stocking wholesaler" to give Western Distribution "instant access to a group of customers, a sales force, sales management and an established distributor relationship with key manufacturers," Pacific Power's business plan said. For that purpose Pacific Power targeted its principal supplier Western States Electric Inc., a 9-year-old Portland-based firm. Pacific Power planned to complete the acquisition September 1984 and have Western Distribution up and running soon thereafter.

Pacific Power encountered its first stumbling block in the summer of 1984 when Western States rejected Pacific Power's offer to purchase the company.

A Western States official declined to say exactly why the offer was spurned.

Undeterred, Pacific Power decided to proceed to set up Western Distribution.

Pacific Power Jan. 28 this year applied to PUC for approval to sell its materials management group assets to Western Distribution. In February it filed for authority to contract with Western Distribution to have Western Distribution handle its procurement and supply operations.

Those two filings have drawn fire from several sides.

PUC staff testimony in September argued "utility diversification exposes the ratepayer to several risks" including potential loss of quality of utility service and increased costs. Especially in cases where utilities diversify into unregulated operations that transact business with their own regulated operations, the PUC faces special problems in insuring utilities provide "safe and adequate service at fair and reasonable cost," the staff said.

PUC staff also noted the potential for a

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regulated utility to obscure true costs of its unregulated subsidiary. In the case of Pacific Power's request, PUC staff judged the utility's accounting procedures inadequate. Staff members alleged Pacific Power underestimated Western Pacific's start up cost by approximately \$600,000 and already had charged Western Distribution-related operational costs to utility accounts.

Larry Olson, Pacific Power treasurer, contested the PUC charges, saying differences between estimates of start up costs resulted from differences in definitions and said identified operational costs had been reclassified. He noted PUC staff and PacificCorp now agree start up costs were in the neighborhood of \$500,000.

PUC staff also pointed to the fact Western Distribution's targeted 20 percent rate of return was higher than utilities' authorized overall 12 percent. Staff members observed Western Distribution's earning such a return could lead to ratepayers paying higher-than-allowed rates.

And PUC staff objected to Pacific Power's stripping itself of essential utility functions—in this case procurement and delivery—and turning them over to a subsidiary on the grounds such a transfer weakens the quality of utility service and introduces potential additional cost of service.

And PUC staff observed potential benefits to Pacific Power's utility customers were too small to offset the negative aspects of the proposal.

PUC staff in September concluded Pacific Power's application was not in the public interest and should be denied.

Pacific Power's proposals drew fire from another sector: electric materials suppliers who would be in direct competition with Western Distribution. These included North Coast Electric Co., EOFF Electric Co., Taylor Electric Supply Inc. and Pacific Power's prior acquisition target, Western States Electric. These companies, along with the National Association of Electric Distributors intervened in the application review.

"The rest of us have to compete in the marketplace," said one company officer who did not wish to be named. "We have no problem competing, but everybody should be in the business on the same basis, competing on a fair basis."

He characterized the proposed arrangement between Pacific Power and Western Distribution as "a sweet deal. If it makes money, [PacificCorp] stockholders win. If

it doesn't, its customers pay."

Dick Sadler, an attorney representing the intervening electrical supply companies, said the companies are concerned not only about "structurally inherent cross-subsidizing," but that Western Distribution would enjoy an unfair advantage in dealing with large Pacific Power electricity customers. Western Distribution would be able to obtain inside information about potential customers' supply need far in advance of the marketplace.

"Intrinsic auditing issues" also will make it an expensive proposition for the PUC to properly monitor Pacific Power's relations with Western Distribution, Sadler also said.

"My clients' position is that unless benefits are substantial, the proposal shouldn't be approved. It shouldn't be approved at all," he concluded.

PUC staff members also suggested potential distributors would decline to submit bids for contracts with Pacific Power, because of the utility's special relationship with Western Distribution. Such an effect would cause the utility to pay an artificially high price for procurement contracts, they said.

Stung by the unexpected opposition, Pacific Power withdrew its proposal to transfer assets to Western Distribution and significantly modified its proposal for Western Distribution to conduct the parent firm's materials management. Moreover, "we've made a lot of effort to build up confidence with PUC staff," Jim Watson, Pacific Power controller, said.

Frank Taussig, PUC assistant commissioner for utilities, acknowledged Pacific Power's modifications constituted "the skeleton of a compromise." And a November PUC staff review of Pacific Power's modified proposal noted Pacific Power's efforts to alleviate problems. But the staff continued to see significant problems with the proposal and clung to its recommendation to deny the utility's application.

Given PacificCorp's extensive diversification—nearly 30 percent of the company's consolidated revenues are derived from scores of subsidiaries, many not utility-related—PUC's extensive attention to Pacific Power's applications seemed extraordinary.

"In and of itself, WDSI [Western Distribution] is not especially significant," said Bill Robertson, Pacific Power's vice president for strategic planning and public affairs. But the agency

approached the application "as a case study," he said.

Richard Elliott, PUC senior economic analyst, agreed Pacific Power's initial applications came at a time when PUC was putting together general guidelines for such situations. But, he noted, "It's not as though the utilities haven't been aware" of principles the PUC has used to deal with "affiliated-interest transactions" since 1974.

Last week PUC's Taussig was guardedly optimistic his agency could reach a settlement with Pacific Power and the intervening electrical supply companies. Following a Dec. 9 pre-hearing conference, he said Pacific Power has agreed to return the bulk of its essential management functions to the utility. It has agreed to buy from Western Distribution at prices reflecting costs of goods with an allowance for overhead. And the company has acknowledged since shareholders are to benefit, it, rather than ratepayers, should pay for any increase in bookkeeping costs.

At press time, all parties were working under the pressure of a PUC-imposed deadline of Dec. 20 for submission of a new, compromise agreement. Taussig said the draft of a potential compromise was under review by his staff.

If a compromise is not reached, the PUC will proceed with hearings on Jan. 15 and 16.

Even if these parties reach an agreement, two other intervenors in the case—the Citizens Utility Board and the Utility Reform project—have until Jan. 7 to ask PUC to proceed with a hearing. To date, both have been relatively inactive. And Dan Meek, attorney for the Utility Reform project, said the project will not participate in the hearings.

As events unfolded in Oregon, Pacific Power obtained approval for the proposed arrangement with Western Distribution from utility commissions in Washington, Wyoming and Montana. And in Idaho, the utility commission said it didn't have authority to rule on the application. Since March this year Western Distribution has been operating in Wyoming and Washington, Watson said.

If terms of a compromise agreement were too constraining, would Pacific Power abandon it plans for Western Distribution in Oregon?

Pacific Power's Watson wouldn't say. But he noted, "We won't get into something futile."

Pacific Power proposes ground rules for spinoff

ARTICLE FROM

THE BUSINESS JOURNAL

WEEK OF JANUARY 6, 1986

By JOHN M. VILLAUME

Pacific Power and Light Co. last month took what may be a major step toward settling a long-standing dispute with the Oregon Public Utility Commissioner (PUC), four electric supply companies and the National Association of Electrical Distributors.

Pacific Power on Dec. 20 filed a settlement agreement with the PUC. The document, drafted by Pacific Power in response to strong objections on the PUC's and electrical supply companies' part, outlined conditions under which its wholly owned subsidiary, Western Distribution Services Inc., would operate.

An agreement among all parties would eliminate the need for hearings scheduled Jan. 15 and 16 and presumably would pave the way for PUC approval of restricted operations for Western Distribution. However, at press time, persons close to the case said it was questionable whether the intervening electrical companies would approve the agreement as it stands.

If approved, the agreement would set ground rules for similar future applications, sources said.

The dispute in which Pacific Power has found itself enmeshed for nearly a year arose out of the company's intentions to spin off its in-house materials management group as a subsidiary—Western Distribution Supply Inc.

And they feared Pacific Power could obtain inside information concerning customer needs, information it might share with Western Distribution, thus giving its subsidiary an unfair advantage.

In response to those concerns, the proposed settlement submitted by Pacific Power provided that:

- Pacific Power will not transfer its Oregon-based property and inventory of supplies to Western Distribution.

- Western Distribution in any year will limit its Oregon sales to Pacific Power to no more than \$6.5 million worth of specified "general stock replenishment supplies."

- If Western Distribution's annual sales to Pacific Power are more than \$5.5 million and Pacific Power attempts to seek rate relief, the utility will have to justify such sales.

- Western Distribution will charge Pacific Power no more than "landed costs"—procurement cost plus freight charges—for supplies shipped directly from manufacturers.

- Pacific Power will pay a fixed annual fee of \$460,000 for administrative procurement costs, but Western Distribution guarantees Pacific Power \$150,000 in annual administrative savings the first year of the agreement, escalating to \$300,000 over five years.

As originally envisioned, Western Distribution would handle Pacific Power's procurement and materials management. Western Distribution also would compete with other electrical supply companies to sell to utility companies, industrial contractors and utility construction companies in Oregon, Washington, Idaho, Montana, Wyoming, northern California and parts

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of Utah approximately \$350 million worth of equipment and supplies each year.

Western Distribution set its sights on capturing 10 percent of that market in a five-year period.

Pacific Power's application—the first by a utility company to obtain approval for a spin-off subsidiary—met with stiff resistance.

PUC staff rejected Pacific Power's initial applications on the grounds the proposed transfer of Pacific Power assets to Western Distribution, stripping Pacific Power of essential managerial functions, Pacific Power's potential subsidization of Western Distribution's operations and other aspects of the company's proposal would endanger reliable delivery of electrical energy at a reasonable cost. Western Distribution's arrangements with Pacific Power could lead to ratepayers paying

more than necessary, PUC staff claimed.

Electrical supply companies intervened, objecting to what they saw as Pacific Power—and eventually ratepayers—subsidizing Western Distribution.

- Pacific Power will not seek recovery from Oregon ratepayers for Western Distribution's start-up costs.

- PUC staff will have access to Western Distribution's books to audit the company's transactions with Pacific Power. Pacific Power agrees to pay the cost of an outside audit to determine whether terms of the agreement are being met and will not seek recovery from Oregon ratepayers.

- Pacific Power agrees not to use its current or proposed utility operations as a direct or indirect method for soliciting or procuring Western Distribution sales to Pacific Power's retail customers.

Frank Tauvix, assistant PUC commis-

sioner for utilities, last week said the agreement goes a long way toward allaying earlier PUC staff concerns—primarily because the utility commissioner's staff can review Pacific Power's rate requests.

"They can go ahead and pay Western [Distribution] \$1 million for a toilet seat," Tauvix said. "We don't care. But they can't get recovery from the ratepayers."

At least one electrical supply company spokesman wasn't so sure he was satisfied with the proposed agreement. Bill Hocken-Smith, vice president for finance at Western States Electric Inc., emphasized no one should assume the companies will agree to the draft proposal.

Hocken-Smith said the intervenors last week had not yet met to decide on their response and probably wouldn't until early this week. "We ain't done yet," he cautioned.

ARTICLE FROM

THE OREGONIAN

Proposal by PP&L draws fire

Reorganization of purchasing questioned

By PATRICK O'NEILL
of The Oregonian staff

Pacific Power & Light Co. is trying to convince the Oregon Public Utility Commissioner that a proposal to reorganize the company's purchasing department will not hurt the utility's ratepayers.

The reorganization is opposed by electric equipment suppliers who fear the move could bring unfair competition and is questioned by the Citizens Utility Board, which is concerned that it might bring more harm than good to PP&L's customers.

Utility officials say they want to convert part of PP&L's purchasing department into a wholly owned subsidiary — Western Distribution Services Inc. — enabling PP&L to take advantage of volume discounts and pass savings along to ratepayers.

But Frank Taussig, assistant public utility commissioner, said the proposal could weaken the utility's management structure and give it an incentive to buy supplies at unreasonably high prices.

"We're concerned that PP&L will transfer a management function to a subsidiary," Taussig said. "Our attitude is that essential management functions should be kept by the parent company. . . . We think it (purchasing) is a pretty important function."

The agency is proceeding carefully. This is the first time in Taussig's recollection that an Oregon utility has asked permission to strip off an "essential management function."

Taussig also worries that the arrangement might encourage PP&L to buy high-priced supplies from Western and that PP&L might pass higher equipment costs along to its ratepayers while sending the profits from Western's operations to stockholders of PacifiCorp, parent company of PP&L.

Tim Watson, PP&L controller, insists that is not the company's intent.

"We proposed setting up a supply subsidiary because we saw advantages for our customers," Watson said. "It's not our intention to have our customers subsidize the subsidiary."

Watson said the arrangement would benefit customers and shareholders alike. The utility could get lower prices because Western would buy in higher volumes to satisfy its own needs as well as those of other buyers, he said.

Those benefits would offset PP&L customers' rates by \$248,000 annually during the first few years of operation and gradually would increase if Western grows as planned, Watson said.

The diversification would allow PacifiCorp to enter an electrical supply market Watson estimates is worth \$200 million to \$400 million a year in the Northwest and Alaska.

"This is a market that is not adequately served," he said. "If we can just get 10 percent of that, that's \$20 million to \$40 million a year."

The utility already has won permission for the reorganization in Wyo-

ratepayer subsidies.

Tuesday, Watson said he believed the company and the FUC were close to an agreement after several months of talks.

In its original application early in 1985, PP&L had asked for permission to transfer a 72-person purchasing operation, \$460,000 worth of equipment and \$3.5 million in inventory to Western.

"We ran into a political buzzsaw on that one," Watson said. The utility now is asking to transfer 20 employees. No equipment or inventory would be purchased from PP&L.

FUC staff members who have studied the proposal express deep misgivings about it.

Richard R. Elliott, senior economic analyst with the agency, testified in prehearing proceedings earlier this month that "the new proposal still poses significant problems, is not in the public interest and therefore should be denied."

Among the difficulties Elliott listed were:

- Sharing warehouse facilities between PP&L and Western might result in PP&L paying more than it should for Western's operations.

- Minimal and uncertain benefits to ratepayers from the arrangement.

- Difficulties in auditing transactions between Western and PP&L for procurement contracts that are competitively bid.

Linda Williams, attorney representing the Citizens Utility Board, sees dangers in the PP&L request.

"If a regulated utility spins off enough essential elements, it leaves behind only a shell that's subject to review," she said.

She said she generally agrees with the objections of the FUC staff members.

Neither Taussig nor Watson knows for sure what compromises might come out of the hearing. Taussig said the possibilities are numerous: Western might agree to sell supplies to PP&L at Western's wholesale cost. Western might include a "modest profit margin" along with enough auditing controls to ensure PP&L paid a fair price.

In any event, Taussig said, the FUC is concerned primarily with fairness for the ratepayers.

Officials say they want to take advantage of discounts, passing savings along.

ming, Idaho, Montana and Washington. Watson said a denial of PP&L's application in Oregon might make it impossible for Western to operate in all states but Wyoming, where the utility had a separate supply distribution network. Washington, Idaho, Montana and Northern California would be served from a distribution center in Wilsonville. That center, now owned by the utility, would be shared by PP&L and Western under the company's proposal.

The FUC has scheduled hearings into the proposal beginning Dec. 9 in Salem. Four Oregon electrical supply companies and the National Association of Electrical Distributors have filed as intervenors in the case, contending that because of the close relationship between Western and PP&L there is little chance that anyone could be sure that ratepayers would not subsidize Western's operations.

"What we're concerned about is not that we'd have a competitor," said Richard Sadler, Portland attorney representing the supply companies. "New competitors come and go all the time."

Sadler said his clients are worried that they would face unfair competi-

ARTICLE FROM

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PP&L gives up defense of subsidiary's actions

By JOHN M. VILLAUME

"Concerned and embarrassed" by revelations made in hearings before the Oregon Public Utility Commissioner (PUC), Pacific Power & Light Co. last week withdrew its application for approval of transactions with its wholly owned subsidiary Western Distribution Service Inc.

Pacific Power conceded it had lost credibility in the eyes of the commissioner's staff and agreed to take steps that will cleanly separate the two companies by June 15 this year. The company also noted it had taken measures to rectify "operational and procedural problems identified in testimony."

Company officials were reluctant to speculate on the long-term implications of Pacific Power's action. But one observer argued the commissioner will be reluctant to approve utility company spinoffs in the future, especially when they involve transactions with the parent company.

Last week's events stemmed from a 1984 Pacific Power decision to set up a subsidiary using Pacific Power's personnel, technical ability, and the assets of its in-house materials management group. As originally envisioned, the subsidiary, Western Distribution Services Inc., would procure, store and deliver supplies to Pacific Power. It also would sell supplies to other utilities in Oregon, Washington, Idaho, Montana, Wyoming, northern California and Utah.

Pacific Power's original business plan anticipated Western Distribution would capture as much as 10 percent of an estimated \$350 million regional market.

In the fall of 1984 Western Distribution began operations, using Pacific Power's warehouse in Wilsonville, Ore. In January last year, Pacific Power submitted an application to the Public Utility Commissioner seeking approval to sell its materials management group assets to Western Distribution. A separate application the following month sought commissioner approval for Western Distribution to handle Pacific Power's procurement and supply operations.

Pacific Power's two applications sparked heated controversy.

PUC staff argued that higher rates for Pacific Power's ratepayers might result from the undetected subsidizing of Western Distribution by its parent, the cost of monitoring Pacific Power's transactions with Western Distribution and the subsidiary's targeted 20 percent rate of return (8 percentage points higher than PUC's allowed rate of return for utilities).

In September last year PUC staff concluded Pacific Power's application was not in the public interest and should be denied.

Electrical materials supply dealers who would compete with Western Distribution also objected to Pacific Power's proposal. North Coast Electric Co., EOFF Electric Co., Taylor Electric Supply Co. and Western States Electric, along with the National Association of Electric Distributors claimed Western Distribution's close ties with Pacific Power would put independent suppliers at an unfair disadvantage.

Pacific Power attempted to mollify objections from both quarters by withdrawing its proposal to transfer assets to Western Distribution. It also agreed to perform its own in-house procurement and materials management. And it offered to limit the type and dollar value of services Western Distribution would perform for Pacific Power.

These and other concessions embodied in a Dec. 20 proposed settlement agreement led PUC's assistant commissioner for utilities, Frank Taussig, to be optimistic that all parties would reach a compromise. But intervenors in the case remained dissatisfied and pressed the PUC for full hearings.

Embarrassing testimony for PP&L

Testimony during those hearings by Kamee Shotwell-Williams, a member of Pacific Power's procurement staff, proved to be embarrassing for the firm.

Shotwell-Williams revealed that Western Distribution had ordered electric cable and guy wire for its inventory at what proved to be relatively high prices. Shortly after it placed its order, the price of both supplies dropped. Before the supplies were delivered Western Distribution arranged with Pacific Power personnel to cut separate purchase orders. And Pacific Power took delivery at what was, by then, higher-than-market prices.

"I was surprised and concerned" by Shotwell-Williams' testimony, PUC's Taussig said. "It appeared PP&L was not following business practices that protected its ratepayers."

Interpreted in their worst light, the two incidents were evidence Western Distribution had taken advantage of its close relationship with Pacific Power to protect itself by passing costs on to its parent and eventually to Oregon ratepayers. And that was "exactly the kind of scenario the intervenors have been screaming about since the beginning," said Dick Sadler, attorney representing the intervening electric supply companies.

Marcus Wood, attorney for Pacific Power, emphasized that when Shotwell-Williams brought the incidents to the attention of her superior, he was incensed and took measures to insure that "any routings that smell funny are going to stop."

Wood also pointed out price differences were relatively small. Consequently costs that might have been passed along to Pacific Power's ratepayers would be minuscule. He also emphasized Pacific Power had adjusted its books to pass the costs back to Western Distribution.

However, Wood was quick to concede "the point of the incident in my view and that of Pacific is not the dollars. The point is that isn't the way we do business. It's not acceptable behavior on the part of staff."

Bob Moench, Pacific Power executive vice president, likewise was contrite. "Western Distribution, like Caesar's wife, has to operate beyond reproach," he said. Pacific Power has "lost its credibility with [PUC] staff. And we have to re-establish that."

Materials submitted to the PUC last Thursday outlined measures the two companies either had or would take to insure Western Distribution operated separately from its parent. Pacific Power had re-established its independent purchasing function. Its staff would be located outside the Wilsonville facility by June 15 this year. Pacific Power shareholders would pay relocation costs.

By the same date, Western Distribution would move its operations and supplies out of Pacific Power's Wilsonville facilities. In the meantime, the subsidiary would pay Pacific Power rent.

Seventeen Pacific Power staff members would be transferred from PP&L's to Western Distribution's payroll. And Pacific Power stipulated it had no current plans to resubmit its Western Distribution applications.

Western Distribution has received approval from utility oversight commissions in Washington and Wyoming and will continue to sell to Pacific Power in those states.

ARTICLE FROM
PACIFIC POWER & LIGHT'S
INTERNAL PUBLICATION

Of current interest

WDSI case reinforces Pacific's mission

Controversy surrounded Pacific's application to do business with Western Distribution Services, Inc. in Oregon. It's an issue I'd like to share with you.

We asked Oregon's Public Utility Commissioner to approve "affiliated interest" transactions between Pacific and WDSI, our wholly owned supply subsidiary. Under Oregon law, the PUC has authority to review transactions between regulated utilities and their affiliates to ensure the transactions are in the customers' interest.

The WDSI case proved to be a tough one. We took some flak on it, particularly from WDSI's competitors. They claimed WDSI had an unfair market advantage because of its relationship with Pacific. The case received considerable attention in the media, and it was the subject of a legislative hearing last year in Salem.

This winter, the PUC staff asked some very difficult questions about Pacific's business transactions with WDSI. Frankly, we were embar-

rassed by some of the answers we provided.

We felt our credibility with the Oregon PUC — and our customers — was on the line. We decided that the best course of action was to withdraw the affiliated interest application for WDSI's Oregon operations. WDSI will not do business with Pacific in Oregon.

In light of the WDSI case, the executive council has taken a close



Dave Bolander
President

look at Pacific's diversification policy. We wanted to clarify Pacific's position on the important public policy issues that arose from the WDSI case.

The council's main conclusions were:

- Our primary emphasis will continue to be electricity sales. As a secondary interest, we will over time develop new energy services and products which meet society's changing energy needs.
- Pacific's shareholders will shoulder the risks and rewards of new enterprises.
- Electric customers will not subsidize affiliated business ventures. We do not believe cross-subsidization of utility subsidiaries should occur.
- Pacific will do business with an affiliate only when it benefits both our shareholders and our customers.

We have always operated this company in a highly ethical fashion as spelled out in our conduct policy. I'd say we've learned from the WDSI case, and we're going to continue applying that knowledge in our future ventures.

Distributors Check Utility Wholesaling Gambit

NAED and four member companies have successfully countered an attempt by Pacific Power & Light to enter the electrical distribution business.

By John Paul Quinn
Editorial Director

MARCH 13, 1986, marked a major victory for four West Coast distributors—Western States Electric; Eoff Electric; Taylor Electric Supply; and North Coast Electric; along with the National Association of Electrical Distributors—when Pacific Power & Light Company (PP&L) withdrew its own application for authority to engage in business transactions in Oregon with its wholly owned subsidiary, Western Distribution Service, Inc. (WDSI).

PP&L had proposed that WDSI be permitted to sell electrical supplies directly to PP&L as well as to the independent wholesale marketplace. The distributors and NAED had contended from the start that, given the relationship between PP&L and WDSI, there was no way to ensure that ratepayers would not subsidize the subsidiary's operations.

The withdrawal of the petition by the utility came after more than a year of mounting controversy that culminated with damaging testimony being given by a PP&L employee that, rather than saving ratepayers money, transactions between parent and subsidiary had already resulted in higher costs being passed on to consumers.

Creation of WDSI

PP&L formed WDSI in September, 1984, one of many moves by the utility to diversify its business.

The original plan called for WDSI to supply PP&L with all of its material needs as well as to sell to other utilities in Oregon, Washington, Idaho, Montana, Wyoming, Utah and northern California. In addition, the subsidiary would enter the independent electrical distribution marketplace, targeting large industrial accounts.

PP&L estimated that the subsidiary would have sales of \$14 million in its first year, growing to \$30 million in five years, capturing 10% of a \$350-million regional market.

But one local electrical distributor, Western States Electric, had sensed early on that the operation proposed by the utility could pose serious problems for the free market electrical distribution business in the area on the one hand, and for PP&L's ratepayers on the other.

Early in 1985, Western States Electric had opposed an attempt by PP&L and other utilities to change Oregon's "affiliate interest transaction" legislation. This legislation restricts the ability of a regulated utility to create an unregulated affiliate and then do business with that unregulated affiliate. The utility had supported liberalizing

the current statutes to make such transactions easier to carry out. Largely as a result of Western States' intervention, PP&L was unsuccessful in its attempt to change the law.

It should be noted that, in 1984, PP&L had sought to purchase Western States, one of its principal independent suppliers, and the company had rejected the tender offer.

Application Filed

In January and February of 1985, PP&L pressed on with its plans, filing two applications in Oregon: one was an affiliate interest petition which sought regulatory permission for PP&L and WDSI to do business with each other; the second was to sell the PP&L materials management group assets—about \$4.5 million in inventory—to WDSI.

While waiting for the applications to be processed, PP&L went forward, transferring its entire 70-person purchasing department to a new WDSI facility located in Wilsonville, a suburb of Portland.

A number of local electrical distributors watched these developments with growing apprehension. Then, in June of last year, four of them—Western States, Eoff, Taylor and North Coast—together with NAED, filed an intervenor petition, opposing the PP&L applications. Their position was essen-

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tially that the WDSI operation would not be in the best interests of ratepayers who would run the risk of having to subsidize it.

Dick Sadler, a Portland attorney engaged to represent NAED and the distributors, began to prepare the case. Sixty-seven interrogatories were filed and numerous depositions of PP&L employees were taken. At this time, Hearings Examiner Patricia Tompkins concluded that NAED's counsel was entitled to full discovery—whatever PP&L documents were required for preparing the case. As a result, some 7,000 pages of documentation were obtained from PP&L. Some of this represented material that the PUC staff had requested earlier from the utility, but which had not been forthcoming.

A number of accounting irregularities came to light at this time:

- PP&L had been charged for some \$400,000 worth of WDSI expenses;

- PP&L's obsolete inventory control computer system was to be replaced by a new system with software specifically developed to interface with third-party business;

- WDSI people were being paid by PP&L, even though they were spending a substantial amount of time working on WDSI activities.

Distributors Testify

In September, 1985, the distributors filed written testimony before the Public Utility Commissioner of the State of Oregon. The following are pertinent excerpts from that testimony, along with some explanatory comments they provided to TED.

Mike Munch, president of Western States Electric, expressed the distributor view in a nutshell:

"Running an electrical distributorship and a company storeroom are two completely different operations. Everything about PP&L's system—its warehouse, its trucks, its personnel and its office system—was designed to operate as a company purchasing and stores operation. It simply won't work as an electrical distributorship. If they get away with this application, either the service to PP&L will take a nose dive, or the ratepayers will pick up the extra expenses. I personally believe both will happen."

This question of subsidization by ratepayers was picked up by Allen Tooke, Western States Electric vice

president, who observed:

"There is no distributor in the industry that could support the type and size of staff, warehouse facilities, computers, organizational structure, and truck fleet that WDSI has in operation on the profit margins in this industry, unless the ratepayers or some other entity is picking up the costs of that operation... Whatever justification exists, if any, to support this system, it is certainly not a viable commercial business."

Bill Hockensmith, vice president of



"This case has dramatically highlighted the suspicion with which regulators must view entry of utilities into so-called free market enterprises..."

—Sadler

finance and treasurer of Western States Electric, who is also a certified public accountant, studied PP&L's financial projections which were intended to justify WDSI's formation. He made these observations:

"All of the alleged benefits (related to WDSI's formation) are directly attributable to the net profits earned on outside third-party sales, and my analysis of their own (PP&L's) projections indicate that, in fact, there will be no net profits on the outside third-party sales... (PP&L's own projections) show a net income, after tax, for the five years 1985-89, of about \$125,000 on a gross sales volume of \$252,510,000. This indicates an approximate return

on sales of .05%... This shows that WDSI is not going to be a profitable entity in the long run. It shows at best that this entity would be a break-even operation, and, if the projections are off by as little as 2.6%, WDSI will lose money... No prudent businessman would make an investment in such an entity with the kinds of returns projected."

Economic Realities

Joe Eoff, president of Eoff Electric Co., discussed the PP&L venture in terms of Oregon's current business climate. He said:

"The general decline of Oregon's economy and the disastrous decline of the wood products industry have put the industrial electrical distribution business into a serious and long-term recession..."

"Because of shrinking markets and the belt-tightening measures taken by the remaining distributors, the competition for business in the State of Oregon is fierce, extremely competitive and chaotic... There is absolutely no way any new industrial electrical distributor could expect to make a legitimate profit in the next few years in this state..."

"I have to believe that the principals of PP&L and WDSI are as aware of these market realities as I am. Therefore, if they understand this market and nonetheless wish to expend a great deal of money in pursuing this application, I have to assume that they have some other methods of maintaining a profit base that are not available to private industry, otherwise, the application makes absolutely no economic sense..."

"It is my belief that PP&L and WDSI intend to make a profit in the industrial electrical distribution business in two ways, both of which are either unethical or unfair. The first of these is to bury their overhead costs in the structure of the combined operation, which has the effect of passing these costs on to the ratepayers..."

"Secondly, the economic coercion that a monopolistic public utility can exert on major industrial customers is overwhelming... Any disruption or delay in electrical power is potentially disastrous to any end user... (and) even a minor change in the way electrical rates are calculated can have enormous economic consequences to

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the industrial customer... Another way the utility can coerce the industrial customer is through the design of its specifications... The utility can design the interface equipment between the industrial customer and its facilities in a fashion such that the customer is virtually forced to purchase the items from the utility...

Inventory Problems

Bill Klein, vice president and general manager of Taylor Electric, zeroed in on the dissimilarity of inventories for utility and industrial/commercial markets. He stated:

"I am convinced that the WDSI operation is not suited to compete in the industrial and commercial electrical area. I do not believe that the current employees have the training or the skill to deal with this highly complex area... We estimate that it takes in excess of 10 years to train someone on our staff to handle and sell the inventory items involved. In the industrial and commercial areas, it is not sufficient that our employees just know the items by name or general description...

"[Furthermore], there is very little, if



"I have to assume that PP&L has some other methods of maintaining a profit base [for WDSI] that are not available to private industry..."

—Eoff

any, crossover between the inventories carried by a private utility such as PP&L and those maintained to service industrial and commercial accounts... Generally speaking, a utility handles those items necessary to maintain the electrical power distribution operation from the source to the meter base. Our commercial and industrial operation is entirely geared to providing products from the meter base into the actual facility... I would estimate that less than 10-20% of our total inventory would have any application to a utility's operation...

"[Additionally], electrical utilities have always purchased the vast percentage of their items by dollar volume directly from the manufacturers. The manufacturers have long had the custom of providing their big-ticket items to utilities directly at a cost even lower than that charged to major distributors... Large manufacturers may be unwilling in the future to allow a utility these very handsome discounts if they know that some utility is operating an electrical distribution business and that some items sold to the utility directly may end up in the hands of third-parties. It is very conceivable

New Member Leads Distributor Defense

Western States Electric, the firm that first opposed PP&L's incursion into the wholesaling marketplace, joined NAED during the course of the proceedings.

Mike Munch, president of the company, has this to say about the outcome of the case:

"Needless to say, we're relieved by the way things turned out. It was a long year's battle. Timewise, it was an enormous drain on our company. And our point all along was that we never minded them being in the business as an independent distributor—our fight was against the way they went about setting up the subsidiary."

"The victory was not only for distributors, but for contractors, manufacturers and reps," says Bill Hockensmith, vice president, finance of the company. "The outcome relieves the great pressure that was put on the entire industry."



Western States Electric executives (from left) Mike Munch, Bill Hockensmith and Allen Tooker convened regularly in the long campaign to oppose the utility's application.

"Incidentally," Munch adds, "the support of the other distributors and NAED was just tremendous. Earlier, we had felt like David going out alone against Goliath. But just knowing that an Association like NAED was there, helping and supporting us, was an enormous lift, because we had our highs and lows as the battle went on."

"We were also quite impressed at

the speed and commitment NAED demonstrated in coming to the assistance of a very new member," observes Hockensmith. "It's an organization that's acutely oriented to its members and one we're proud to be a part of. We are a utility market distributor; before we joined we didn't realize that NAED is an Association for specialized distributors like ourselves as well."

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that their response to such a situation would be to cut off the direct user discounts to such a utility...

"PP&L's engineers, designers and operations people could court the favor of a large industrial customer with virtually limitless advice and consultation, and all this would be absorbed by the ratepayer as an operational expense. In effect, PP&L can turn its engineers, its customer-relations people, and virtually anyone else working for the company into a sales arm of WDSI without any cost to WDSI. This creates a non-competitive environment which would be virtually impossible for the independent distributor to combat..."

"Here, the game of 'freeze-out' becomes very significant. By the time the private electrical distributors even find out there is work to bid on, the job will probably be, as a practical matter, gone..."

"I believe the current operation will intentionally or unintentionally cause the ratepayers to subsidize a substantial commercial activity."

Second Round

In October, PP&L responded with their pre-filed written testimony and presented revised forecast tables which admitted that the level of benefits to ratepayers was less than originally projected. At the same time, the utility withdrew one of the two petitions it had filed—the one by which it sought to sell the PP&L materials management group assets to WDSI.

Bill Hockensmith of Western States Electric returned to testify regarding PP&L's new forecast tables. He concluded that rather than saving ratepayers \$112,000, it would actually cost them \$314,000 more if the utility purchased through WDSI. He then went on to make the following points:

"Throughout the testimony [of PP&L], there is the unstated assumption that PP&L currently has substantial excess capacity in its existing operating system that would allow WDSI to use this excess capacity at no extra cost to PP&L. If this excess capacity is truly as large as has been implied, there is a significant issue as to whether or not the company's current management practices are prudent and really designed to protect the ratepayers."

And with regard to WDSI's proposed cost allocation methods, he had

these observations:

"The [WDSI] flow chart graphically demonstrates the complexity of the entire allocation system. Its complexity alone raises serious question as to its accountability. Complexity creates a substantial hardship for anyone attempting to audit a company's financial records... Based on my experience as an auditor in a major public accounting firm, the currently proposed allocation system is one of the more elaborate I have encountered. Since accounting is itself a cost to any company, there would be no justification for an accounting system as a complex as this in normal private enterprise."



"I believe the WDSI operation will intentionally or unintentionally cause the ratepayers to subsidize a substantial commercial activity."

—Klein

Settlement Agreement

As the year drew to a close, the staff of the Oregon Public Utilities Commissioner suggested that all parties attempt to reach a compromise agreement. The Commissioner's staff was instrumental, after extensive negotiations, in drawing up a complex tentative agreement which substantially scaled down the utility's initial proposal.

However, after the agreement was drawn up and carefully reviewed, the intervening parties decided that cer-

tain key areas—notably cross-subsidization and auditing capabilities—were not adequately addressed and that major loopholes still existed for the utility.

The intervenors requested and were granted a full hearing which began in January, 1986. At this time, a number of manufacturers were subpoenaed to give testimony regarding PP&L and WDSI purchases from their firms. Some anomalous purchasing situations came to light.

One regional sales manager testified that his firm sold exclusively through distributors. The company was approached by WDSI which said it would be acting as PP&L's distributor and asked to be added to the manufacturer's distribution network. But the company did not choose to add WDSI to its network, and accordingly only offered to sell product to WDSI at a standard distributor discount rate. This rate was not as economical as the special discount rate it offers its own distributors when it is known their end user is a volume consumer such as a utility.

The manufacturer was asked, "Since those direct, special discounts are not available [to WDSI], the products that PP&L is currently buying from you [through WDSI]—they are paying more than they would have paid before; is that correct?"

The answer was: "Yes."

A second manufacturer also testified that the prices quoted to WDSI were higher than those quoted to its "preferred" distributor network. Yet in both cases, the utility continued to use WDSI as its procurement arm.

As damaging as this testimony was, it paled in comparison to that given by a witness from PP&L itself.

Endgame

The intervenors called Kamee Shotwell-Williams, a member of the purchasing group at PP&L.

She was asked about a particularly complex bid put out by WDSI for cable in which the bid was fragmented both by state and commodities and given to one set of prospective suppliers in Oregon and only to suppliers that had agreed to make WDSI a distributor outside of Oregon.

Williams testified that "there was a general response from manufacturers... basically wanting to know what

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Counsel's Commentary

TED contacted Portland attorney Dick Sadler who represented NAED and the member companies in the PP&L hearings and asked him to comment on the salient features of the case.

TED: When you took the case, what were your initial thoughts?

Sadler: From the very beginning, we knew that this would be a hard case to win. PP&L is a powerful corporation with virtually unlimited legal and financial resources.

TED: The "affiliate interest" principle—a company doing business with its own subsidiary—was central to the case. Could you explain its implications?

Sadler: At the very core of any affiliate interest application is an inherent conflict between the utility, which wants to keep costs low, and the affiliate, which wants to keep the costs of its goods and services provided to the utility high to maximize its own profits. The important point about this case is not so much that an individual application has been withdrawn, but that potential abuses inherent in all affiliate interest cases were dramatically demonstrated.

This case and others like it should cause utility commissioners to be very cautious in granting such applications. I believe that affiliate applications should not be granted at all unless the realistic projected economic benefit to the ratepayer is

very large and that checks and balances built into the approval process assure that subsidization will not occur.

TED: What about subsidization?

Sadler: Throughout the case, PP&L assured the public that its internal accounting and auditing systems would prevent the utility from subsidizing WDSI's operations. As a result of the PP&L employees who forthrightly testified to the problems WDSI created inside the purchasing structure of PP&L, the Public Utility Commission was provided a rare opportunity to see how affiliate operations work. Once those practices were revealed, the application was in trouble.

we were doing because they were slightly confused."

She said that the manufacturers were also surprised at the low quantities involved for which they could not give volume pricing.

Faced with this situation, Williams approached her superiors and said that if bids were sought under the old, pre-WDSI procedures, the company would get a better price. She testified that the response was: "I know. But we are doing things differently now."

And then there was a peculiar case of two purchase orders being cut for the same item—first by WDSI, then by PP&L.

The purchasing department, according to Williams, originally ordered a certain volume of conductor cable from a manufacturer for delivery to WDSI. Then, before it was delivered, a new purchase order was sent requesting that the material be delivered to PP&L.

Williams testified that, after the cable had been ordered, WDSI discovered it could be purchased cheaper elsewhere. WDSI then attempted to cancel the order. When the manufacturer refused, Williams was ordered to issue a new purchase order and have the material shipped directly to PP&L.

When asked if any explanation had been given for this procedure, Wil-

iams testified: "I was told that WDSI did not want the higher priced material in their inventory." And she added that she had been told the same procedure had been followed in another situation involving guy wire.

When asked if these new procedures were allowed to stay in place would this have an adverse effect on the company's costs, she responded that she thought it would, adding that some of the complex procedures had resulted in shortages at various of the company's locations.

The hearings were recessed on January 31, the same day that Kamee Shotwell-Williams gave her testimony.

On March 13, the day the hearings were scheduled to continue, Tim Watson, PP&L controller, withdrew the company's petition to do business in Oregon with its subsidiary, WDSI.

While this does not mean that WDSI is expressly forbidden to operate in the independent electrical wholesaling marketplace, its ability to do so has been seriously undermined.

The following month, in PP&L's employee bulletin, company president Dave Bolender acknowledged: "This winter, the PUC staff asked some very difficult questions about Pacific's business transactions with WDSI. Frankly, we were embarrassed by some of the answers we provided. We felt our

credibility with the PUC and our customers was on the line. We decided that the best course of action was to withdraw the affiliate interest application..."

Concluding Arguments

At the conclusion of the case, Dick Sadler, the distributors' and NAED's Portland counsel, commented: "This has been a long and hard-fought struggle, and we are pleased that PP&L has now withdrawn its application. This case has dramatically highlighted the suspicion with which the utility regulatory system must view the entry of regulated utilities into so-called free market business enterprises through affiliate interest applications.

"The economic incentives for the utility to subsidize its affiliate operations at the expense of the ratepayers is enormous. In addition, it is virtually impossible for the regulation system to monitor a utility affiliate effectively once it is established. As a result, regulation of affiliate interest applications is one of the thorniest problems facing utility commissioners.

"Fortunately, in this case, the evidence and testimony we got from the utility itself graphically demonstrated the problems inherent in affiliate cases. PP&L was left with little choice but to make the extraordinary step of withdrawing its entire application." ♦

Unity uses critical ad to get work

By Bert Caldwell
Staff writer

The manager of Inland Power & Light Co. has mailed copies of an advertisement criticizing the company to every Washington utility as a way of drumming up business for two firms controlled by Inland.

The ad placed in The Spokesman-Review June 29 by area line contractors asks members of the cooperative if they are aware of the firm's contracting and supply activities and the possible impacts losses there could have on rates.

Inland manager Arnold Brauff, who called the ad "a case of sour grapes," also points out the savings other utilities can realize by allowing Utility Construction Services Inc. and Utility Material Services Inc. to bid on their contracts.

"That ad may be the best thing that every happened to Inland," Brauff said.

The ad cites the results of bidding last month for a contract with the Okanogan County Public Utility District. The engineer's estimate for the bid was \$72,000. Utility Construction won the bid for \$50,732.

Bids from four Spokane contractors — Astec Electric Inc., Wilson Construction Inc., Power City Electric Inc. and WICO Inc. — ranged from \$73,310 to \$90,907. Those four and R.C. Hughes Corp. paid for the newspaper ad.

"Do you think that Utility Construction Services is 46 percent more competitive than the lowest of four private contractors that together have over 100 years of experience in building power lines?" the ad asks.

Astec General Manager Andy Dahlman said the Okanogan bid was the last straw after a series of bid lettings all the way to Western Washington in which private contractors were underbid by Construction Services.

"They've consistently lost their shirt on this work," he said. "I guarantee you they're not doing it for \$50,000."

He said Astec crews working near Construction Services' worksite have monitored its work. Men from another Inland job in the Mica area are being brought in during the week, then are paid overtime on weekends.

"It is likely there will be a loss on that (Okanogan) project," WICO Manager Tom Tilford added. "Their bidding practices indicate a lack of sophistication."

The result, both contractors said, will be higher rates for Inland customers, who will have to cover Construction Services' losses or the higher overtime wages paid workers by Inland.

Somebody's subsidizing it somewhere," Dahlman said.

"They're just tilting at windmills," Brauff responded.

The construction and materials businesses are subsidiaries of Northwest Rural Electric Cooperative, he said. However, Inland is the only remaining member of the organization, which once had 12 cooperatives as members. Inland controls Northwest and the subsidiaries, and the boards of both are filled with Inland board members.

"You might call NREC a holding company," Brauff said, comparing Inland's relationship with Utility Construction and Utility Material to Washington Water Power Co.'s ties to subsidiaries such as Iron.

Inland has management contracts with the subsidiaries, which pay the utility costs plus 10 percent for any services provided. The construction work is done by union crews under the direction of a superintendent and foreman.

Brauff said the superintendent, who has 30 years of experience, prepares the bids. Utility Construction, he noted, has been outbid by some of the companies that paid for the advertisement.

"I would like it if we could underbid on every job," he said.

Brauff said the subsidiaries were incorporated two years ago. They did about \$2 million in business each in 1985, he said, and earned profits both years.

He rejected what he said were contractor efforts to make Utility Construction and Utility Material look like public utilities with unfair advantages over private firms.

"UCS is private enterprise," he said. "It's certainly not government enterprise. The intent of this organization is to make money and to keep our rates down."

Brauff said the subsidiaries help because their profits go to Inland, but losses will be sustained by the subsidiaries alone.

"We're not going to have losses," he added.

Inland has raised rates about 2 percent over the last two years, he said.

Dahlman and Brauff said they have received several responses from contractors and utilities who saw the advertisement.

"We've got a number of copies from utilities asking 'What is this guy, nuts?'" Dahlman said.

Brauff said three utilities have inquired about Utility Construction bidding on their projects. People he spoke to at a meeting last week of the Northwest Public Power Association, he said, thought the ad was "ludicrous."

Co-op members, the target of the advertisement, have been silent, Brauff added.

Dahlman said there would probably be little change as a result of the ad and Brauff's use of it to promote Inland, but he added, "We've got everybody thinking about it anyway."

ARTICLE FROM

FORBES

JUNE 16, 1986

People buying utility stocks for their diversification prospects should listen carefully to Don Frisbee. He's been there.

Mixed rewards



*Pacificorp Chairman Don C. Frisbee
For a bureaucratic mind-set, the exhilaration of taking risks.*

By James Cook

LOTS OF UTILITY STOCK has moved lately on the strength of the industry's diversification prospects. But ask Don C. Frisbee, 62, chairman of Portland, Ore.'s giant Pacificorp, how successful the utility industry's current diversification is likely to be, and he says: "Not very."

A dash of cold water, that, but Frisbee speaks with authority. Under his management, Pacificorp has diversified further, faster and more successfully than any other company in the business, and averaged a 14.9% return on equity and a 9.6% annual growth rate for its pains. Last year Pacificorp's Pacific Power subsidiary generated only 64% of its \$245 million profit—the rest coming from its coal and precious metals business, 90%-owned Nerco, and from its telephone and telecommunications operation, 87%-owned Pacific Telecom.

So why is Frisbee skeptical about the prospects of other utility outfits' doing likewise? He explains it in these terms:

Pacificorp didn't diversify to sop up its excess cash, as most utilities are doing these days. When Pacificorp started acquiring outside businesses, it did so in the ordinary course of its business, cash was short. "The evolutionary process is important," Frisbee says. "Cash-driven diversification isn't likely to turn out very well," he adds, referring to the fact that many utilities are diversifying because they no longer need to build new plants and thus have cash to spare.

Pacificorp got into coal 20 years ago because it wanted a source of supply for its Wyoming power plants. And it got into precious metals because it mines gold and silver the same way it mines coal: as an earth-moving operation. Telecommunications? Pacificorp considered selling a telephone subsidiary it acquired in an electric acquisition, but then decided that business fit in neatly with its regulatory experience. It now provides long-lines service in Alaska and local service there and in eight other states.

More recently Frisbee moved on into financial services, because, he says, Pacificorp already had a lot of financial skills within the company—equipment leasing and commercial lending—and because by this time Pacificorp was beginning to generate excess cash like everyone else. "When we started," Frisbee half jokes, "we thought we'd become a bank." With the acquisition last year of Northwest Acceptance and Hyster Credit, Pacific Credit has \$400 million in assets and

will earn maybe \$5 million this year.

As Frisbee sees it, PacifiCorp's diversification helped break the conservative, security-oriented, almost bureaucratic mind set that afflicts many utility managements. "It has given a real lift to the organization," Frisbee says, "and enabled us to develop a more risk-taking attitude."

Even so, PacifiCorp's diversification has not been an unmitigated triumph. It had to learn by doing, as John Dewey always advised, and the price was a \$44 million loss over the past year or so in an abortive oil and gas exploration venture, another \$78 million loss in various ill-conceived venture capital and telecommunication manufacturing ventures.

What Frisbee is looking for is what everyone else is looking for: a decent return, superior growth and some fit with his company's skills. Which means, Frisbee says, service businesses. But it's not easy to find businesses that will perform as well as electric utilities, whatever their problems. Nerco's operating income is up only 29% since 1981, Telecom's 34%, while electric utility income is up nearly 85%. And PacifiCorp's electric business has not only grown faster, it now yields a better return: 16%, vs. 9% for Telecom, 15% for coal.

What of the future? At the moment it looks less than sensational. The way competition keeps nibbling away at its market, Frisbee doesn't expect the electric business to grow more than 2% a year. The prospects for coal and precious metals are even less heartening. Declining prices have cut profits in coal and generated losses in precious metals, with little immediate relief in sight. Telecommunications is picking up, though its prospects will remain uncertain as the industry adjusts to the breakup of AT&T. Clearly, while diversification has helped, it has been no panacea.

Though the SEC will require PacifiCorp to write off an additional \$9 million this year on oil and gas, last year's losses in oil and manufacturing are mainly behind. But, otherwise, practically everything is out of whack. Overall, first-quarter earnings were down 18%. Electric earnings were off 14%, Nerco's 67%, and Telecom's 8% gain wasn't enough to offset these declines. Things are so uncertain that at this point Frisbee is making no predictions about whether PacifiCorp will be able to match even 1985's somewhat underpar results.

So the lesson is obvious: Don't expect diversification to work wonders in the utility industry any more than it has in railroads or natural gas. ■

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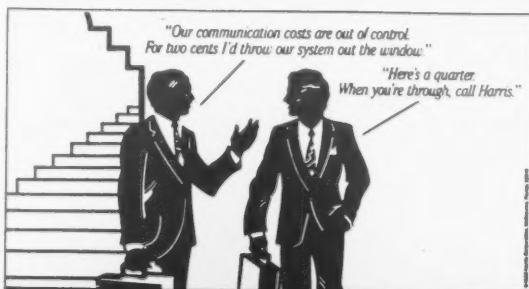
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Chairman RANGEL. Thank you. Mr. Rothschild.

**STATEMENT OF EDWIN S. ROTHSCHILD, ENERGY POLICY
SPECIALIST, CITIZEN ACTION**

Mr. ROTHSCHILD. Thank you, Mr. Chairman. I am Edwin Rothschild. I am the energy policy specialist of Citizen Action. It is nationwide federation of 24 State citizen organizations with a combined membership of 1.6 million citizens. Our organizations at the State level and the Federal level have been involved in utility matters, rate matters for many years.

I want to apologize for my cold, and I will also be brief because of that as well.

Section 203(e), in our view, clearly became a part of the Tax Reform Act because utilities wanted to see that provision there and the benefits that would flow from it.

In the same respect, consumers see the benefits of getting rid of section 203(e) and having back the money that rightfully belongs to them; namely, the excess deferred taxes. We certainly would like to see a much swifter refund of those moneys, since it has already been collected and since it is in excess.

But it is not in this bill, and that is one reason why we think H.R. 1049 is a very modest first step in dealing with this issue and other issues related to excess deferred taxes and their refunding to consumers. We think the bill does not go far enough. It certainly does not address an issue that we have been concerned with for a long time—phantom taxes.

We clearly understand why the utilities that will be testifying here today are so concerned about this issue. Because if they were not, they would not be here, and they would not be making the argument.

Mr. Chairman—

Chairman RANGEL. Would the witness suspend until somebody closes that door?

Mr. ROTHSCHILD. Certainly.

[Pause.]

Mr. ROTHSCHILD. Repealing section 203(e) is in the public interest. It is fair and it is eminently reasonable. It will simply permit State regulatory commissions to consider the issue as it regards each utility on a case-by-case basis. So there exists the possibility that in some cases consumers will not obtain refunds within a short period of time as we would like, but over a longer period. It could even be 10 to 20 to 30 years.

That, we think, is the major weakness. We believe that Congress must require that all excess deferred taxes be refunded to all consumers within a period of no more than one year. We do not think there is any justification for allowing utilities to hold on to their customers' money, particularly since they are not repaying it to the Federal Government at any time in the future, for any period longer than that.

Even though H.R. 1049 does not require immediate refunds for excess deferred taxes, and even though it does not specifically prohibit utilities from collecting excess deferred taxes, and even though it does not prevent collection of phantom taxes, it is still a

modest first step in correcting a blatant, multimillion-dollar overcharge of the Nation's electric utility, natural gas and telephone consumers. In that regard, Mr. Chairman, we support and urge passage of H.R. 1049.

[The statement of Mr. Rothschild follows:]

Statement of
 Edwin S. Rothschild
 Energy Policy Specialist
 Citizen Action
 before the
 Subcommittee on Select Revenue Measures
 Committee on Ways and Means
 U.S. House of Representatives
 on
 H.R. 1049
 The Utility Ratepayer Refund Act of 1987

December 14, 1987

Mr. Chairman and members of the committee, my name is Edwin S. Rothschild and I am the Energy Policy Specialist with Citizen Action, a nationwide federation of 24 state citizen organizations with a combined membership of 1.6 million people.

For many years Citizen Action and its state affiliates have fought for fair and reasonable utility rates. Our members have challenged efforts by electric utility companies to overcharge residential consumers for excessive costs associated with mismanagement and imprudent investment decisions in the planning, construction or operation of electric generating facilities. We have fought gas pipeline attempts to deny consumers refunds based on their illegal gas purchasing practices. We have opposed electric and natural gas utility company pressure on regulatory agencies to shift risks and costs from shareholders to ratepayers. We have criticized the trend among utilities to use ratepayer funds to diversify into unregulated enterprises.

And we are here today as part of our continuing vigilance over and fight against regulated utility industry activities aimed at preventing consumers from obtaining what is rightfully theirs. We are here, in short, to support passage of H.R. 1049, the Utility Ratepayer Refund Act of 1987, introduced by Rep. Byron Dorgan last February, because this bill would return to state regulatory commissions their rightful authority to refund to consumers excess deferred income taxes.

Mr. Chairman, H.R. 1049 is a modest bill. In fact, we believe it does not go far enough to correct the defects of the current regulatory process by which utilities can successfully elude payment of billions of dollars in refunds to their residential, commercial and industrial customers.

H.R. 1049 would repeal Section 203(e) of the 1986 Tax Reform Act. This provision was included in the tax bill, because the utilities wanted to retain the benefit from a massive multi-billion dollar involuntary loan from their customers, instead of refunding the excess in deferred tax revenues collected. When Congress decided to reduce the corporate tax rate from 46% to 34 percent, the utilities suddenly realized that they would have to refund the reduction on the tax revenues, which were collected in advance and under the 46% tax rate, to their customers. According to the National Association of Regulatory Commissioners, the reduction in tax rates left electric, natural gas and telephone utilities with a \$19 billion surplus. This was money collected from consumers in excess of what the utilities owe to the U.S. Treasury.

In states and communities across the country refunds amount to hundreds of millions of dollars. In the state of Connecticut, for example, Connecticut Light & Power owes ratepayers nearly \$63 million, of which 37% is owed to residential customers. In Indiana, the Northern Indiana Public Service Company, a company which is seeking stockholder approval to reorganize into a holding company so that it can more easily invest in unregulated ventures, customers are owed almost \$140 million of which 19% would be refunded to residential users.

It is also interesting to note, Mr. Chairman, that the Columbia Gas System, which owes its customers nearly \$145 million is here today fighting against H.R. 1049. The Columbia Gas System is a company that was found to have committed "fraud and abuse" in its natural gas purchasing practices, an action which cost its customers hundreds of millions of dollars. This lawbreaking company is here today seeking once again to prevent its customers from obtaining what is rightfully theirs. Columbia's gas customers are located in Ohio, Pennsylvania, Virginia, West Virginia, Maryland, the District of Columbia, and New York.

Repealing Section 203(e) is in the public interest. It is fair and eminently reasonable. Repeal of this utility-sponsored giveaway will not require utilities to immediately refund their excess deferred taxes. It will simply permit state regulatory commissions to consider the issue as it regards each utility on a case by case basis. So, there exists the possibility that in some cases consumers will not obtain refunds within a short period of time, but over a very long period -- 20 to 30 years. We believe that this is a major weakness in the legislation. We believe Congress must require that all excess deferred taxes be refunded to all consumers within a period of no more than one year. There is no justification for allowing utilities to hold on to their customers' money for any longer period.

Many utility company executives these days are behaving like children unwilling to face and take responsibility for the consequences of their own actions. They blame government, they blame environmentalists, they blame consumers, they blame changing economic conditions -- everyone but themselves for their imprudent investment decisions. Unwilling to live with the results of those decisions, they are looking for every opportunity to force their customers to underwrite investment mistakes.

In recent years many utilities have experienced record profits, but they claim that they just don't have the money to refund their excess deferred taxes right now. Many utilities, in fact, have already squandered this money on costly, non-competitive nuclear power plants that should never have been built in the first place. Others are using the excess customer-provided cash to purchase non-regulated businesses such as insurance companies, and real estate.

It is simply outrageous to permit utilities to delay for 20 or 30 years refunding this \$19 billion customer over-charge. For consumers who are struggling to make ends meet, to make their mortgage payments, to put food on the table, or to keep their farms, the promise of a refund two or three decades from now is little consolation. Asking 35 million senior citizens to wait until 2007 or 2017 for their final refund installment adds even more injury to the insult.

It is the height of Chutzpah, Mr. Chairman, for utilities to oppose H.R. 1049. We all know that they get very upset when customers don't pay their bills. They charge late payments. They threaten to cut off service, and they cut off service. If they are owed refunds, you can be sure that their waiting time is very, very short. Utility customers are only asking for the same

kind of treatment with regard to the repayment of excess deferred taxes.

There is a presumption on the part of utilities that one, this is their money. It is not. And two, that they need it more than their customers. They don't. Like the utility, consumers would rather have money in their pockets today than tomorrow. Why should utilities be able to collect and use ratepayer dollars, rightfully belong to consumers? We urge that H.R. 1049 be amended to require immediate refunds.

Some utilities will complain that by refunding these excess deferred taxes, their financial conditions will be jeopardized. This is not the concern of Congress. Financial reorganization or municipalization are legitimate market corrections for managerial incompetence. Ratepayers' dollars should not be held hostage by utility managements which have been unable, because of their imprudent or mistaken investment decisions, to keep their companies solvent. Service, be it natural gas transportation, electric generation and distribution or telephone, will continue. The consumer will be served. It is only a utility's shareholders and creditors who will have to bear the risks. But that is what competitive markets are for.

H.R. 1049 has other glaring weaknesses, Mr. Chairman. According to Joseph W. Jacobs and Thomas Mittlesteadt, authors of "Excess Tax Reserves and the Tax Reform Act of 1986" published in the June 29, 1987 edition of Tax Notes, H.R. 1049 addresses the issue of returning to ratepayers the "excess tax reserves already collected" by utilities, but does not fully address the problem of "continued collection of excess taxes." They argue that in passing Section 203(e) Congress was silent on the issue of whether or not to "allow utilities an additional 'windfall' measured by the collection of excess deferred taxes above and beyond those already accumulated as of the effective date of the Tax Reform Act of 1986."

The authors make the analogy with a cup of liquid. There is no need, they say, to fill the cup above the brim. Funding the utilities' deferred tax account with revenues to fully cover future tax liabilities is all this is required. Allowing utilities to collect more is totally without justification and a repudiation of the concept of fair and balanced regulation. In the words of Jacobs and Mittlesteadt "It would be completely unfair to require ratepayers to bear the further burden of continued additions to the deferred account when it is agreed by all that the account is sufficiently funded for its purpose." In this regard then, Mr. Chairman, we urge that H.R. 1049 contain language that specifically prohibits the accumulation of additional excess tax reserves currently allowed by Tax Code sections 167 and 168.

Finally, Mr. Chairman, H.R. 1049 does not address the larger issue of "phantom taxes," associated with the regulatory accounting process known as "normalization." The issue is simple and straight forward. Utilities collect from consumers in their rates revenues for taxes owed to the federal government, but which are not paid to the federal government in the year that those taxes are collected, if ever. According to NARUC deferred federal income taxes for electric, natural gas and telephone utilities at year-end 1986 amount to \$73 billion. Ratepayers should only be required to pay rates which reflect taxes which are actually paid. H.R. 1049 does not correct this enormous loophole through which the nation's utilities obtain additional forced consumer financing.

Even though H.R. 1049 does not require immediate refunds for excess deferred taxes, even though it does not specifically prohibit utilities from collecting excess deferred taxes and even though it does not prohibit collection of "phantom taxes," it is still a modest first step in correcting a blatant multi-billion dollar over-charge of the nation's electric utility, natural gas and telephone customers.

Chairman RANGEL. Thank you, Mr. Rothschild for Citizen Action.

Consumer Federation of America, Mr. Cooper.

**STATEMENT OF MARK N. COOPER, DIRECTOR OF RESEARCH,
CONSUMER FEDERATION OF AMERICA**

Mr. COOPER. Thank you, Mr. Chairman. In 1985 the regional Bell operating companies, who provide basic telephone service to about 80 percent of the Nation's consumers, had deferred tax and investment tax credits of about \$2 billion. They are four of the five largest single pots of excess deferred tax. In that year they invested about \$1.2 billion in their unregulated subsidiaries. Those subsidiaries lost between \$0.5 and \$1 billion. Thus, at least three-quarters of the cashflow from these tax breaks, and perhaps all of it, was eaten up by unregulated subsidiaries of the telephone companies that are not engaged in the provision of basic telephone service.

But that is only the beginning of the story. In 1985, these companies funded virtually all of their growth needs from internal funds, which most corporations are unable to do; the national average is about 75 percent. They also declared dividends at twice the rate of other large corporations. They declared over \$4 billion in dividends, which represents a dividend yield from 5.4 percent for Bell South, to 6.4 percent for Pacific Telesis. The average rate for the 1,000 largest corporations in the country was about 2.8 percent.

PacTel is an interesting example. In 1985 it had the highest dividend among the regional Bell operating companies. And the staff of the California Utilities Commission found and made charges of cross-subsidy of its unregulated subsidiaries. Note that it possesses the largest single pot of deferred tax in the Nation.

Now if the baby Bells had stayed out of their money-losing, unregulated subsidiaries and declared dividends at the national average rate, even without the cash flow from these tax breaks, they would certainly have had \$1 billion and probably over \$2 billion more to invest in plain old telephone service; what we call POTS. So much for the argument that they need this cash.

We do not generally care what they do with their money. They have a right to invest it wherever they want and lose it or make a bundle. But we do care what they do with their money when it is our money. And we do have a right to ask how it is used. Holding ratepayers money under the false pretext of paying taxes was bad enough. Using it to fund forays into unregulated, nontelecommunications businesses adds insult to injury.

The Consumer Federation is not the only one to reach this conclusion. Judge Harold Greene who oversees the antitrust case against AT&T wrote a powerful decision just this December and I recommend it to you. He reached similar conclusions about the conduct of the baby Bells. He cited evidence of cross-subsidy, diversion of profits to unregulated companies, and excess earnings, in denying their request to get into long distance and equipment businesses which they had been denied under the modified final judgment.

Recognizing that the effort to hold onto these funds has nothing to do with investment for funds in basic telephone service, but

funds used to get into every other manner of business, it becomes clear that these companies are seeking an unfair advantage.

In competitive industries the tax reduction will be largely passed through to consumers. The lowering of the tax rate is a generalized reduction in the cost of doing business. Any firm that tried to hold onto the money would find its market share reduced by competition. The tax cut will be transformed into lower prices by competition. That is why we were early supporters of the cut.

Since other businesses pay large phone bills, the effort by telephone companies to avoid passing the tax cut through or hold onto excess taxes, is really an effort to gain an advantage in terms of cash flow.

The incentives in the old Tax Code were misplaced. The utility industry, which has a significant monopoly base was least in need of the incentives, but they benefited most. Delaying the return of these funds will only delay the elimination of this distortion in the cashflow of the Nation's economy.

Thank you.

[The statement of Mr. Cooper follows:]

TESTIMONY OF
DR. MARK N. COOPER
DIRECTOR OF RESEARCH
CONSUMER FEDERATION OF AMERICA

Mr. Chairman and Members of the Committee,

My name is Dr. Mark N. Cooper. I am Director of Research of the Consumer Federation of America (CFA) with offices at 1424 16th Street, Washington D.C., 20036. CFA, founded in 1968, is the nation's largest consumer advocacy organization. CFA's membership encompasses more than 200 national, state and local consumer, senior citizen, low-income, union, farm, labor, public power and cooperative organizations representing more than 35 million people.

I appreciate the opportunity to testify before the committee today. The Consumer Federation has testified numerous times on telecommunications issues before this and previous Congresses. We were early and active supporters of tax reform. We frequently have testified on the taxation of utilities.

In my remarks today I will focus on the reasons that the local telephone companies in general, and the Regional Bell Operating Companies (RBOCs) in particular, do not need to continue to hold the excess taxes that they collected from the nation's ratepayers under the old tax code. It is overwhelmingly clear that the money belongs to consumers and that equity demands that it be returned quickly. However, utilities have argued that economic efficiency requires that they keep the money as long as possible. In the case of all utilities, but particularly the telephone companies, that argument is absurd.

ACCOUNTING FOR UTILITY TAXES BEFORE REFORM:
RATEPAYERS PAID BUT THE GOVERNMENT DIDN'T COLLECT

Under the new tax law, telephone companies will collect less taxes from ratepayers and pay more to the federal government. That was what tax reform was supposed to be about. In fact, because of the special accounting treatment of utilities, tax reform as applied to utilities provides the purest manner of tax reform possible.

Under standard public utility accounting, utilities collect taxes from ratepayers at the highest corporate rate. In the past, that was 46 percent. However, because of accelerated depreciation and tax credits, utilities did not pay these taxes to the Treasury. They deferred the vast majority of the taxes collected. As a result, consumers paid but the government did not collect. Utilities held the money.

The telephone companies claim that they need this money to finance their investments. They have been asking public utility commissions not to lower their rates to reflect the reduction in taxes and they would have Congress believe that they need to hold onto their excess deferred taxes for the same purpose.

OTHER COMPANIES WILL BE FORCED TO PASS THE BULK
OF THE TAX CUT THROUGH TO CONSUMERS

The economic rationale underlying this argument is simply wrong. In competitive industries, the tax reduction will be largely passed through to consumers. The lowering of the tax rate is a generalized reduction in the cost of doing business. Any firm that tried to hold onto the money would find its market share reduced by the competition. The tax cut will be

transformed into lower prices by competition.

The incentives in the old tax code, which has now been reformed, were badly misplaced. The utility industry, which has a significant monopoly base, is least in need of incentives to invest. Yet, they benefited most from the old code. In 1985 alone, the telephone industry had deferred taxes of over \$3 billion.^{1/} The effective tax rate on this industry was far below that of the majority of other industries.

Since other businesses pay large phone bills, the effort by the telephone companies to avoid passing the tax cut through or to hold onto excess deferred taxes is really an effort to gain an advantage in terms of cash flow that other corporations do not have.

TELEPHONE COMPANIES ARE EARNING EXCESSIVELY HIGH
RATES OF RETURN AND HAVE EXCESSIVE CASH FLOWS

The local telephone companies, who have been leading the charge to hold onto this cash flow, did not in the past and do not now need the cash. The telephone companies have used their cash flow to declare huge dividends, not to invest in capital equipment (see Exhibit 1). The dividend yield of the RBOCs since

EXHIBIT 1

DIVIDEND YIELD:
TELEPHONE COMPANIES COMPARED TO TOP 1000 CORPORATIONS

DIVIDENDS AS A PERCENT OF MARKET PRICE

	1984	1985	1986
AMERITECH	7.3	5.5	5.4
BELL ATLANTIC	7.7	5.5	5.4
BELL SOUTH	7.4	5.4	5.2
NYNEX	7.6	5.5	5.4
PACTEL	7.1	6.4	5.7
SW BELL	7.2	6.6	6.0
US WEST	7.6	5.9	5.4
TOP 1000 CORPS.	3.2	2.8	2.9

SOURCES: Business Week, "Scoreboard Special, 1985," "The Top 1000, 1986," "Corporate Scoreboard" (March 16, 1986). For 1986, only the top 900 corporations are included.

their inception has been several times as high as the average for other large corporations in the nation.

Even with the high level of dividends paid, the telephone

^{1/} United States telephone Association, The Negative Effects of Tax Reform on the Telephone Industry: Making Up the \$15 Billion Difference, January 30, 1987.

companies have been financing more of their investment with internal funds than do other large corporations. All corporations rely on a certain amount of debt financing and for companies with monopoly bases, debt can play a larger role, since there is less risk. Generally, competitive industries cover about a quarter of their growth needs with external financing accounting. 2 The telephone companies have been meeting virtually all their needs from internal funds.

Two factors account for this remarkable cash flow. Rates of depreciation have been accelerated far above historic levels and rates of return are three or four points higher than they have historically been or should be. The acceleration of depreciation in 1985 cost consumers almost a billion dollars as did the excessive return on equity.

The RBOCs are earning a return on equity that is about three percentage points higher than the Business Week 900 (see Exhibit 2). Since they provide essentially monopoly services, they

EXHIBIT 2

RETURN ON EQUITY:
TELEPHONE COMPANIES COMPARED TO TOP 1000 CORPORATIONS

	1984	1985	1986	1987
AMERITECH	14.1	14.5	15.0	14.9
BELL ATLANTIC	13.1	13.8	14.1	14.4
BELL SOUTH	13.4	14.2	14.4	13.8
NYNEX	12.9	13.3	13.9	13.7
PACTEL	12.8	12.8	14.1	12.3
SW BELL	12.9	13.6	13.4	12.8
US WEST	13.3	13.3	12.7	12.9
TOP 1000 CORPS.	13.2	11.4	10.4	10.9

SOURCES: Business Week, "Scoreboard Special, 1985," "The Top 1000, 1986," "Corporate Scoreboard" (March 16, 1986; November 16, 1987). For 1986 and 1987, only the top 900 corporations are included.

should be earning less than these firms which generally face strong domestic and foreign competition.

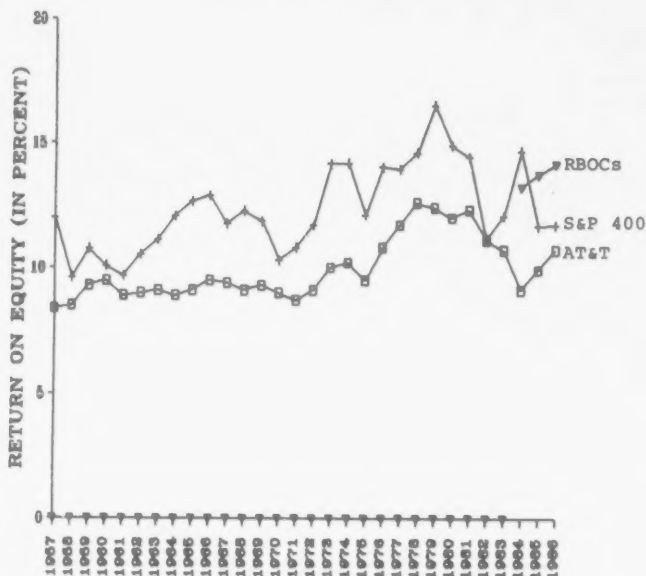
Historically, the telephone company earned less than competitive firms. For example, prior to divestiture, AT&T

2/ For example, the "Corporate Balance Sheet Scoreboard," Business Week, June 24, 1985, estimates that the largest 900 corporations financed only 72 percent of their growth needs internally. Six of the seven RBOCs generated funds larger than their growth needs as defined by Business Week in both 1984 and 1985. The seventh generated 90 percent of its needs internally (Mark Cooper, Local Rate Increases in Post-Divestiture Era: Excessive Return to Telephone Company Capital (Consumer Federation of America, September, 1986).

consistently earned one to two percentage points less than the Standard and Poors 400. At present RBOCs are actually earning almost three percentage points more than the S&P 400 (see Exhibit 3). By this historic standard their earnings are almost four

EXHIBIT 3

LONG TERM RATES OF RETURN



SOURCES: Standard and Poors, Analyst Handbook, A. Kahn "Utility Regulation Revisited," in A.L. Danielson and D.R. Kamerschen (Eds.), Current Issues in Public Utility Economics (Lexington: Lexington Books, 1983); Company annual reports.

percentage points too high.

The fact that the local companies continue to possess an essential monopoly on the telephone network was recently attested to by Judge Harold Greene, who oversees the antitrust case against AT&T.

by the finding of the Department of Justice's own expert, these bottlenecks are still so pervasive that only one in one million telephone users is able to bypass them to communicate with his ultimate customers on his

own; the remaining 999,999 users remain strictly dependent for local connections upon the Regional Company monopoly.^{3/}

COMPANIES ARE FUNNELING CASH OUT OF THE INDUSTRY AND DEVOTING
EVER INCREASING AMOUNTS OF ATTENTION TO DIVERSIFICATION

Another indication that the telephone companies do not need this money for the provision of telecommunications services has been their rapid diversification into other activities. As Judge Greene noted, in less than four years after divestiture, the RBOCs

created some one hundred-fifty corporations, partnerships, subsidiaries, and other entities having sometimes but a remote relationship to telephone operations. Business Week has estimated that the Regional companies spent \$1.2 billion in 1985 in acquiring real estate, financial services, software, publishing companies, and the like.^{4/}

Judge Greene estimates that the RBOCs lost almost half a billion dollars in 1985.^{5/} The National Association of Regulatory Utility Commissioners puts the figure at closer to one

^{3/} Opinion, United States of America v. Western Electric, Inc. et al, Harold Greene, September 10, 1987, pp. 216-217.

This firm monopoly cannot be blamed on the existence of regulation, it goes back to the fundamental economics of the network. As the Judge put it

Even if all state and local regulation prohibiting competitive entry into the local exchange market were to be repealed tomorrow, and anyone were free, as a matter of law, to sell local telephone service, the exchange monopolies would still exist substantially in the same form and to the same extent as they do now. The conditions that caused these monopolies to emerge in the first place -- the need for connecting local consumers of telephone service to the telephone company central office switches by means of wires strung or buried throughout America's cities and rural areas and the enormous capital resources required for this project -- preclude any thought of a duplications of the local network.

Only when a practical and economically-sound method is found for large-scale bypass or for connecting local consumers by a different method -- as microwaves and satellites were ultimately found to be feasible for handling long distance traffic -- can the regional companies' local monopoly be regarded as eroded (p. 48-49).

^{4/} Ibid, pp. 157-158.

^{5/} Ibid, p. 159.

billion.^{5/} Judge Greene drew the obvious conclusions from this rush into unrelated activities -- that the companies were likely neglecting their basic function and using monopoly revenues to cross-subsidize competitive activity.

An observer might well be justified in concluding that the participation of the Regional Companies in these far-flung enterprises is bound to diminish their management's interest in and attention to the local telephone business -- that, after all, was these companies' *raison d'être*, and that still is the aspect of their operation most vital to the public, since, under present conditions, if the Regional companies do not attend to local telephone service, no one will or can.

More to the point of the present discussion, however, what is wrong from an antitrust point of view with the combination of (1) telephone rate increases and (2) Regional Company outside ventures is that these ventures appear to have been funded from and are being supported, at least in part, by the local phone rates.^{7/}

The staffs of the public utility commissions in the two largest states, states with the resources and the will to look into the matter, found that the local companies had been engaging in cross-subsidy.^{8/} Both New York and California found extensive evidence of

attribution of executive and management time to the competitive subsidiary that was a small fraction of the economic activity in which it was engaged;

inadequate compensation of time that was billed to the subsidiary;

a complete lack of or inadequate compensation for assets and services utilized by the subsidiary;

cherry-picking the best talent from the parent monopoly company and saddling the parent with costs for training that was more directly related to the activity of the subsidiary; and

6/ Rodney Blythe, Summary Report on the Regional Holding Company Investigations (National Association of Regulatory Utility Commissioners, September 18, 1986), p. 8.

7/ Greene, Opinion..., p. 158.

8/ Department of Public Service, New York, Staff's Initial Brief, Case No. 27420, January 23, 1984; Staff Direct Testimony, Case 28959 -- Rochester Telephone Corp. Need for and Propriety of a Royalty, April 12, 1985; Public Staff division, California Public Utilities Commission, A Report on Pacific Bell's Affiliated Subsidiary Companies, June 3, 1986.

imputation of excessive rates of return for services purchased from the subsidiary;

Judge Greene cited both the excess rate of return and the diversion of profits to non-telecommunications companies in his decision not to allow the RBOCs to enter other lines of business.^{2/}

CONCLUSION: IF THE RBOCs NEED MORE MONEY, LET THEM ASK THE PUCs DIRECTLY, NOT HIDE RATE INCREASES BEHIND THE TAX CUT

The bottom line is clear. The effort by the telephone industry to avoid reducing consumer rates is based on pure greed -- an effort by an industry that was unfairly and unnecessarily given advantages under the old tax code to preserve its advantage. They could easily fund their investments from cash flows that are not bloated by deferred taxes if, they ceased declaring such high dividends (see Exhibit 4).

If RBOCs do need more money for investment or to accelerate their depreciation, they should ask public service commissions directly to grant them rate increases, not use the cover of the tax cut to obscure their intentions. We are confident that public service commissions will deal with these requests, as well as return of excess deferred taxes, in light of the remarkable financial performance of the RBOCs since their creation four years ago.

2/ He argued, citing CFA's earlier analysis of telephone company profits (p.157),

Following the divestiture, the telephone operating companies controlled by the Regional companies requested and were awarded large rate increases almost everywhere in the Nation,* even though their profits substantially exceeded those of comparable corporations. Regional company return on equity amounts to 14.0 percent compared to an all-industry composite of 10.9 percent.**

* The rate increases were frequently requested based on the fact of the AT&T divestiture although divestiture had nothing to do with them.

** Cooper and Kimmelman, "Divestiture Plus Three: Still Crazy After All These Years, 9, Consumer Federation of America, December 1986. Accordingly, arguments such as those of Ameritech, echoed by other Regional Companies, that the entry of the Regional Companies into interexchange services is "essential to [their] financial health... and the viability of their networks" and that unless this is done, they "face a bleak future" (Comments at 48, 50), ring hollow, to say the least. Their lack of substance is underlined by the fact that profits are not being channelled to the local telephone networks by away from them.

EXHIBIT 4

REPLACING INTEREST FREE LOANS WITH REAL INVESTMENT DOLLARS

The following describes the financial situation of the RBOCs in the face of the new tax bill. It applies the approach used by the United States Telephone Association for assessing the impact of the change in the tax law on cash flows.

We estimate that the RBOCs collected about \$3.5 billion in taxes from ratepayers in 1985. Under the new corporate tax rate of 34 percent, they will collect about \$2.6 billion. Thus, the reduction in rates could be on the order of \$900 million.

Under the new tax code the RBOCs appear to lose about 83 percent of their deferred taxes and investment tax credits -- about \$1.8 billion in cash flow. Thus, half of their reduced cash flow will be the result of increased payments to the Treasury.

The RBOCs could easily maintain their internal funds for investment, however, if they paid dividends at the same rate as other corporations in the nation. They have been paying out at a rate that is twice the national average. The difference between their dividend yield and the national average amounts to about \$2.1 billion in excess dividend payouts.

BILLIONS OF 1985 DOLLARS:

	Telephone Industry 2/	RBOCs 3/		
		1985 Actual	1985 as if Tax Law	
			No Change in Dividend	Dividend at National Avg. 5/
Taxes Collected 1/	NA	3.5	2.6	2.6
Net Income	10.1	7.5	7.5	7.5
Depreciation	13.5	10.1	10.1	10.1
Deferred Taxes and ITC 4/	3.3	2.2	.4	.4
Total Internal Funds	26.9	19.9	18.0	18.0
Dividends Paid	8.3	4.3	4.3	2.2
Net Internal Funds	18.6	15.6	13.7	15.8

1/ Assumed full tax rate on net income. This is the accounting treatment mandated by FUCs and used in a United States Telephone Association's (USTA) hypothetical case, The Negative Effects of Tax Reform on the Telephone Industry: Making up the \$15 Billion Difference, p. 19.

2/ USTA p. 6.

3/ Annual Reports.

4/ Calculated as difference between 1984 and 1985 Deferred Taxes and ITCs. The lost deferred taxes and ITC are assumed to be 83% of pre-reform, as per USTA hypothetical.

5/ National average dividends used for non-RBOCs is 2.8 percent.

Chairman RANGEL. Ms. Caplan.

**STATEMENT OF RUTH CAPLAN, EXECUTIVE DIRECTOR,
ENVIRONMENTAL ACTION, INC.**

Ms. CAPLAN. Mr. Chairman, we appreciate the opportunity to testify today in favor of H.R. 1049 introduced by Representative Dorgan of North Dakota.

For typical U.S. consumers, their utilities are now holding \$223 in refunds for them, due to the tax reform bill this committee passed last year. That is the good news. The bad news is that ratepayers may have to wait up to another 30 years to get all their money back.

In each of the districts of this subcommittee, local electric, gas and phone utilities have collected millions of dollars from ratepayers for income taxes that they will never have to pay to the Federal Treasury. These overcharges are now rightfully owed to the customers. Most of us could use these refunds now. Some will not live long enough to see their money returned.

How much money is involved? According to the National Association of Regulatory Utility Commissioners, the potential consumer refunds from the utilities serving the districts of the members of this subcommittee are as high as \$1.2 billion. The amounts for the major utilities serving each of your districts are as follows: In Representative Andrews' district, \$978 million; in Representative Brown's district, \$439 million; Representative Coyne's district, \$344 million; Representative Dorgan's district, \$217 million; Representative Flippo, \$441 million; Representative Judd Gregg's district, \$299 million; Representative Kennelly, \$167 million; Representative McGrath, \$749 million; in your district, Mr. Rangel, \$750 million; Representative Stark's district, \$1.2 billion; and Representative Vander Jagt's district, \$476 million.

I am sure that each one of you have heard from your utilities who are serving your district on this matter.

Our organization has been a strong supporter of the efforts by the Ways and Means Committee to reform the Federal corporate income tax. Previous Federal tax policy brought major distortions to energy supply decisions. In particular, the investment tax credit and accelerated depreciation promoted capital intensive energy production. These tax subsidies favored construction of new coal and nuclear plants over less capital intensive sources, and more environmentally benign energy measures such as conservation and renewable energy.

While some distortions remain, the Tax Reform Act of 1986 was a major step in leveling the playing field among energy competitors in the utility industry.

One only has to note Mr. Abrams' testimony which shows the bond ratings for the utilities in New York to quickly see which utilities are currently involved in nuclear construction programs and which are not.

The final bill also resulted in billions of dollars worth of rate relief for consumers. The drop in the corporate tax rate from 46 to 34 percent lowered the cost of providing utility service to the public. This triggered dozens of rate reviews by State public utility

commissions. The result was billions of dollars in lower rates for all classes of customers; something for which this committee has received all too little credit, and we thank you.

With all the positive elements contained in last year's Tax Reform Act, we were amazed to find this new tax subsidy created. Congress previously left the decision on the treatment of these funds, as other witnesses have testified, to State regulators.

The utility industry admits that these funds in question do belong to the ratepayer. The only issue in dispute is the length of the refund period. Under section 203(e), State regulators have no option but to allow utilities to refund these overcollections to consumers over the remaining economic life of the company's assets.

As has already been testified, this provision was not included in Treasury I, for which we commend the Treasury Department. We, for one, liked that draft. Nor was it in Treasury II, or in the initial markup vehicle of Committee Chairman Dan Rostenkowski.

This measure also was not raised during the numerous hearings on tax reform before this committee except in one sentence by Mr. Hulse, CEO for Pacific Telesis. And it was never mentioned by any witness for the electric utilities. Nor was there any formal or informal vote taken on this section during the bill drafting process. It was inserted in the final days of the House markup without analysis of the final impact on ratepayers. Of course, we now know that over \$19 billion in consumer refunds is at stake in H.R. 1049.

Utility executives argue that ratepayers will be better off the longer a utility retains the refunds. We do not buy that argument. Sluggish demand for electricity has cut the need for new power plants, coupled with their strong cash positions, utilities, as has been testified, are busy diversifying. One utility holding company has even bought the Tampa, FL, minor league baseball team.

To correct the injustice in the Tax Code, we strongly urge this subcommittee to see through the blizzard of opposition that utility lobbyists have stirred up on Capitol Hill, and to report favorably this bill.

We thank you very much for this opportunity to testify.

[The statement of Ms. Caplan follows:]

Statement of
Ruth Caplan, Executive Director
Environmental Action, Inc.

in Support of the
"Utility Ratepayer Refund Act of 1987," H.R. 1049
before the Subcommittee on Select Revenue Measures
of the House Committee on Ways and Means
December 14, 1987

Environmental Action appreciates the opportunity to testify in favor of H.R. 1049, the "Utility Ratepayer Refund Act of 1987" introduced by Representative Byron Dorgan of North Dakota.

For typical U.S. consumers, their utilities are now holding \$223 in refunds for them, due to the tax reform bill this Committee passed last year. That's the good news. The bad news is that ratepayers may have to wait another 30 years to get all their money back.

This tax injustice was created by an obscure provision in the Tax Reform Act of 1986, Section 203(e). When Congress dropped the corporate tax rate, \$19 billion in future utility tax liabilities, called "excess deferred taxes," was forgiven. But at the same time, language was included in the bill that orders state utility regulators to stretch out these refunds for decades.

In each of your districts, local electric, gas and telephone utilities have collected millions of dollars from ratepayers for income taxes that they will never have to pay to the federal Treasury. These overcharges are now rightfully owed to their customers. Most of us could use those refunds now; some will not live long enough to see all their money returned.

How much money is involved? According to the National Association of Regulatory Utility Commissioners, the potential consumer refunds from the utilities serving the districts of the members of this Subcommittee are as high as \$1.2 billion. The amounts for the major utilities in each of your districts follows:

Rep. Mike Andrews (Texas)	
Houston Lighting & Power Co.	\$198.0 million
Southwestern Bell	\$779.9 million
Rep. Hank Brown (Colorado)	
Public Service Co. of Colorado	\$47.0 million
Mountain Bell	\$391.9 million
Rep. William Coyne (Pennsylvania)	
Duquesne Light Co.	\$78.4 million
Bell Telephone Co. of Pennsylvania	\$265.6 million
Rep. Byron Dorgan (North Dakota)	
Northwestern Bell	\$216.9 million
Rep. Ronnie Flipppo (Alabama)	
South Central Bell	\$441.4 million
Rep. Judd Gregg (New Hampshire)	
Public Service Co. of N.H.	\$0.2 million
New England Telephone	\$298.7 million

Rep. Barbara Kennelly (Connecticut)	
Connecticut Light & Power Co.	\$63.0 million
Southern New England Telephone	\$104.0 million
Rep. Raymond McGrath (New York)	
Long Island Lighting Co.	\$162.1 million
New York Telephone Co.	\$587.2 million
Rep. Charles Rangel (New York)	
Consolidated Edison Co.	\$162.6 million
New York Telephone Co.	\$587.2 million
Rep. Pete Stark (California)	
Pacific Gas & Electric Co.	\$429.1 million
Pacific Bell	\$816.1 million
Rep. Guy Vander Jagt (Michigan)	
Consumers Power Co.	\$275.9 million
Michigan Bell Telephone Co.	\$200.5 million

Our organization has been a strong supporter of the efforts by the Ways and Means Committee to reform the federal corporate income tax. Previous federal tax policy brought major distortions to energy supply decisions. In particular, the investment tax credit and accelerated depreciation promoted capital-intensive energy production. These hidden tax subsidies favored construction of new coal and nuclear plants over less capital-intensive energy sources and more environmentally benign energy measures, such as conservation and renewable energy. While some distortions remain, the Tax Reform Act of 1986 was a major step in leveling the playing field among energy competitors.

The final bill also resulted in billions of dollars worth of rate relief for consumers. The drop in the corporate tax rate from 46 percent to 34 percent lowered the cost of providing utility service to the public. This triggered dozens of rate reviews by state public utility commissions. The result was billions of dollars in lower rates for all classes of customers--something for which this Committee has received too little credit.

With all the positive elements contained in last year's Tax Reform Bill, we were amazed to find this new tax subsidy created. Congress previously has left the decision on the treatment of these funds, called "excess deferred income taxes" to state regulators. The Revenue Act of 1978 lowered the top corporate tax from 48 to 46 percent. State commissions handled the resulting utility tax refunds in a wide variety of methods. In each state, utilities had the opportunity to present their cases following the normal ratemaking process. That procedure worked with no complaints from the utility industry.

The utility industry admits that these funds in question do belong to the ratepayer. The only issue in dispute is the length of the refund period. Under Section 203(e), state regulators have no option but to allow utilities to refund these overcollections back to consumers over the remaining economic life of the company's assets.

This provision was not included in either of the two tax reform proposals of the Administration, "Treasury I" and "Treasury II," or in the initial markup vehicle of Committee Chairman Dan Rostenkowski. This measure also was not raised during the numerous hearings on tax reform before this Committee. Nor was there any formal or informal vote taken on Section 203(3) during the bill-drafting process. It was inserted in the final days of the House markup process with little understanding of the final impact on ratepayers. We now know that over \$19 billion in consumer refunds is at stake in H.R. 1049.

Utility executives argue that ratepayers will be "better off" the longer a utility holds on to the refunds. We don't buy that argument. While a few electric companies are in financial shambles because of their nuclear investments, most have been declared "cash cows" by Wall Street. Sluggish demand for electricity has cut the need for new power plants. Coupled with their strong cash positions, utilities are busy diversifying into non-utility businesses, such as insurance companies and real estate. One utility holding company has even bought the Tampa, Florida minor league baseball team.

To correct injustice in the tax code, we strongly urge this Subcommittee to see through the blizzard of opposition that utility lobbyists have stirred up on Capitol Hill. H.R. 1049, the "Utility Ratepayer Refund Act of 1987," has won an unusually broad support from consumer, environmental, business, and regulatory groups and deserves your support. We strongly urge the members of the Subcommittee to favorably report out this bill.

Chairman RANGEL. Thank you, Ms. Caplan. Before the committee takes the testimony of Mr. Kajander, I would like to state for the record that Chairman Rostenkowski has called a meeting of the House conferees on the reconciliation conference. I want to thank Mr. Dorgan for agreeing to chair this meeting in case I am not able to return.

Mr. DORGAN [presiding]. Thank you, Mr. Chairman. The subcommittee will next hear from Mr. Kajander.

STATEMENT OF GARETH R. KAJANDER, CHAIRMAN, ILLINOIS INDUSTRIAL UTILITY CONSUMERS

Mr. KAJANDER. Thank you. My name is Gareth Kajander and I am the chairman of the Illinois Industrial Utility Consumers. We are pleased to have this opportunity to provide a brief perspective on H.R. 1049.

The Illinois Industrial Utility Consumers was organized in April 1986 to communicate the industrial position on utility matters to legislators and other interested organizations. Our group is comprised of 14 large industrial companies with 41 production facilities located across the State. We have over 68,000 employees. Our membership includes Abbott Laboratories, Acme Steel, Alumax Aluminum, Caterpillar, Inc., Deere & Co., General Tire, LTV Steel, Northwestern Steel & Wire, Olin Corp., Owens-Illinois, A.E. Staley Manufacturing Co., Viskase Corp., Wagner Castings, and PPG Industries.

Utility costs are very important to our membership. They represent one of the large cost components to manufacture our products. On an annual basis, in Illinois alone, we spend in excess of \$260 million for electricity and natural gas.

As a result, H.R. 1049 is important to Illinois industry. The Illinois Commerce Commission has estimated that Illinois utilities have overcollected approximately \$1 billion in excess deferred taxes owed to ratepayers. The key utilities in our State include Commonwealth Edison, Illinois Bell, Union Electric, Illinois Power, Central Illinois Public Service, Central Illinois Light Co., Iowa-Illinois Electric, Northern Illinois Gas, and Peoples Gas Co.

Studies by the Electricity Consumers Resource Council show that industrial electric consumers pay rates often in excess of the cost incurred by utilities in meeting their loads. Indeed, a 1986 ELCON survey shows that industrials pay more than \$2.5 billion annually in subsidies to other ratepayers.

The Illinois Industrial Utility Consumers support H.R. 1049. It would drive our rates closer to the actual cost of service. It will also provide much needed capital for investments which will ultimately help us compete in this era of worldwide competition. It should be noted that generally speaking, utilities do not need this capital at this time as their building cycles are complete.

Our members fully support the central theme of this legislation, which allows each State's regulatory commission to handle the excess deferred tax issue on a case by case basis. This takes into account the particular situation of each utility, including their financial health.

Again, we appreciate the opportunity to give our Illinois perspective.

Mr. DORGAN. Mr. Kajander, thank you very much. I would like to ask a couple of questions, first for Mr. Sadler. I have looked through your statement and want to ask you about diversification because it is a question I intend to ask some other panelists from the utility industry.

You are not suggesting that all diversification by a utility company should be prohibited, are you? That is not your position, is it?

Mr. SADLER. No, clearly not. I am not even certain that the regulatory process or legislation could in fact mandate that even if you wanted to. What I am suggesting is that diversification, particularly affiliate interest diversification poses some particularly grave risks to the regulatory structure, and that it should be looked at very, very carefully. And that it is not the unquestioned blessing that has been suggested.

Again, I think that the reason for the—my comments, I think, fall well within what the previous panel suggested. And that is, the pattern of diversification across the country is radically different. One of the companies that I am aware of, PacifiCorp, is highly diversified in a number of cases to the extent that it is no longer even traded. Its companies only are being traded as a utility on the exchanges, which is an interesting comment upon the Treasury Secretary's comments that these investors and stockholders are essentially treated as bond holders.

But my point is that in other cases there is very little diversification. This is just one of the issues that I think the regulatory process on a State-by-State level needs to address. So I think what it does is suggest that it is just one more reason why your bill is appropriate and to allow the regulators to look at this, one State, one company at a time.

Mr. DORGAN. I do not know whether any of the members of the panel can answer this question. Let me ask, if the utility company diversifies and then has a holding company with a corporate group of which one partner is the regulated utility company, the utility company will collect taxes from its customers at the statutory rate. The corporate group will then file a consolidated tax return. In fact, the utility company will not file a separate return, it will be part of the consolidated return.

If you have some winners and losers in the corporate group, it is very likely that the actual income tax rate paid finally by that company is much, much less than the statutory rate being collected by the regulated utility company. Is anybody familiar with that area? Does that strike you as a problem?

Mr. COOPER. As I point out in my testimony, and this is with reference to Judge Greene who has recently gone over in great detail the arguments about the Bell operating companies who do have the largest pots of excess deferred taxes, and he was quite convinced that commingling of money is a problem. He cited the two largest public utility staffs in the country, New York and California, which have recently found such a problem.

And it goes directly to the question of, here is a huge pot of money. It is bloated in a certain sense, certainly in the case of those companies by excess deferred taxes. And it becomes useful

for whatever purposes, and the purposes to which it is significantly being put by telephone holding companies is not the provision of telephone service.

So there is a clear problem, and a very recent finding by a Federal judge, at any rate, that he thinks there is a major problem out there, certainly in the telecommunications industry.

Mr. SADLER. Might I add just a brief comment. I have participated in a number of rate cases, as I am sure a number of the other members of this panel and others have. And as a novice to this in the first instance, I was astounded by the complexity and difficulty facing the regulatory community. Even assuming the most simple, straightforward, integrated utility operation, the process is overwhelmingly complex and difficult.

I think what we are seeing with diversification, affiliate or an unaffiliate diversification, is that the commissioners are now being asked to go back into those consolidated returns and try to pull out of those consolidated returns what was, in fact, the effective tax rate that the utility portion of this diversified company had to pay and try to adjust its rates on that basis.

Quite frankly, I am convinced that if this process of diversification and affiliate diversification is not brought to some kind of understanding and check, the complexities to the regulatory community are so overwhelming that I think these entities will become virtually unregulated. You cannot simply—you just have not the manpower on these staffs to try to ferret all of this information out.

I dealt with a very small, little company and we were in litigation for 18 months, and I felt like we had just begun to touch the surface.

Mr. DORGAN. What if a utility executive says, you are all well-meaning people who represent the consumers out there, but you do not understand the big picture. You do not understand the complexities. You do not understand the long term financing needs. You do not understand the rate stability. You are thinking only of the short term.

Ms. Caplan.

Ms. CAPLAN. I think that while initially in the 1970s some of the consumer groups that were getting involved in rate cases were looking in the short term, I think that turned around very quickly as we saw that, in fact, it was the long-term decisions that the utilities were making that were making the real difference. And therefore, we began to go beyond an individual rate case. We began to look at utility planning.

In the case of New York where I was involved, we were looking at statewide planning. I was involved in the first State energy master plan in New York State very deeply. We looked at long range projections for demand. We began to look at many, many aspects of utility planning.

And today we continue to do that. We look at things like least-cost energy planning, where you want to make sure that the ratepayers money is being used in the most efficient way possible. And frankly, one of our concerns is that when there is a large amount of money, which as has already been admitted is, in essence, a nointerest loan to utilities, incentives to pursue things like least-

cost energy planning are much less than if they have to go out on the market and pay the market going rate on interest.

So I think that consumers do look very much at the long term. It is in our own interest to do so. I certainly will concur with the complexity of rate cases. And it is difficult to understand many of these issues and all the testimony. But there are a lot of consumers who have put a lot of time into this.

I would like to just add one more thing. And that is, as time consuming as it is for State regulators to regulate their own utilities, utilities are also moving toward Federal regulation through the formation of holding companies, taking it out of the hands of State regulators and into the hands of Federal regulators. The complexity is even more when you are dealing with Federal regulators who do not know the State situation.

Mr. COOPER. Having appeared in a couple dozen State public utility rate cases dealing with both electricity and telecommunications, you always hear the contention that the intervenors, whether they are consumer advocates, people's councils, do not understand. I think the financials of the regional Bell operating companies are quite clear. The Government Service Administration itself petitioned 29 State public utility commissions to lower their rate of return, arguing that they had excessive profits.

To add on top of that this interest-free loan and extend it out as far as possible into the future is, as I said in my testimony, adding insult to injury. And I think Judge Greene understands the industry as well, and he clearly believed that our excessive returns, cross-subsidy, and diversion of profits into unregulated affiliates, and therefore, a major problem in the public interest regulation of these telephone companies.

And this, obviously, we will continue to battle over rates of return, depreciation schedules, but this is one very clear abuse of the ratepayer that does not involve a great deal of understanding in light of certainly the financials of that industry.

Mr. DORGAN. Mr. Rothschild.

Mr. ROTHSCHILD. Mr. Chairman, I think your bill addresses this clearly because by turning over the decision to the State regulators, the bill recognizes that they are in the best position to make the judgment as to whether or not it is short term or long term. They are the ones that are going to have all the information available, not just the issue of taxes, but the financial condition of the community, and the other aspects that go into ratemaking.

So that is where the decision is made. Regardless of what utility companies are going to say here, they will go to the State commissions on other issues and say, you have the authority to make these decisions on long term.

Mr. DORGAN. A utility executive said to me not too long ago, that what my bill would do would be to force his company to give back x amount of dollars and injure his company. I said, you must misunderstand my bill. My bill does not force you to do anything. My bill simply removes from Federal law that barrier that was included that prevents State regulatory commissioners from making relevant decisions. So at that point, he amended what he said. Said, yes, you are right, I was overstating it.

This legislation does not force the refund of anything. This legislation gives back to the State regulatory authorities, that authority they have historically had to make judgments on a case-by-case basis with respect to these utility companies.

Mr. COOPER. I would like to make a comment, particularly with respect to that question of replacing the cash, because the Treasury witness also raised it this morning. And we will clearly go into the State public service commissions and argue for a quick return; make no mistake about it.

And the Secretary from Treasury suggested that that would have two negative effects. One, it would force future ratepayers to pay for future plants. We do not see that as a negative effect. The fact that the utility would have to go out and raise money in the capital markets to fund those plants we think is a good thing. They ought to be exposed to the capital market. Because what the capital market will, in fact do, is make a harder, more realistic judgment of the economic value of those plants.

So the long-term interest of the consumer is to have financial markets passing judgment on those plants, rather than have these kinds of funds which had not been subject to that judgment. The long-term view is, we end up with lower cost of service by letting financial markets make that pronouncement.

So that, you are right, the interest rate might be higher on a particular plant, but we will get a better mix of plants and a better choice of investments out of that process.

Mr. DORGAN. Let me confess to you that diversification is part of what piqued my interest in this subject. We have seen many publications describe the diversification going on with respect to the utility industry.

Let me make the point to you that the utility people will make in subsequent panels. They say, what on earth are you talking about, taking money from ratepayers to buy a drug store chain or an insurance company? That does not happen. The fact is, the utility company, which is the regulated company, is allowed a certain rate of return on its base and that is all it is allowed. They will continue, how on earth can you make the case that it is using this money, or any other pot of money, to diversify into other areas? That is simply not true.

Mr. Sadler, how would you respond to this utility assertion?

Mr. SADLER. The issue, unfortunately, is complicated. It would be nice if I were able to tell you that the moneys that come in in every circumstance, the cash-flow can be immediately traced to a diversify structure as Commissioner Bradford indicated this morning. That simply is not the case. And you have to get into the intricacies of the ratemaking process to understand what is really going on.

Let me give you a couple of examples, however, of what I think is the problem here. When the company raises this capital in the first instance to create the kitty—in other words, what happens is it assumes a tax rate lower than in fact its real tax—or higher than its real tax rate will be. Then it has this cash available to it.

Now in certain circumstances, what happens to that cash, that capital infusion in the company can be fairly regulated. If the com-

pany is operated under the Utility Act of 1935, it is subject to Securities and Exchange Commission rulings, et cetera.

However, in the particular case in my company that I am more familiar with, PacifiCorp, there is no distinction between the utility's operation and, if you will, the holding company. They are not separate legal entities. PacifiCorp is the, if you will, umbrella company. The power company is simply a doing business appellation. So what happens is that that excess cash that flows in through the rate structure essentially goes onto the balance sheet of the company.

Now I think what most utility regulators would say, and I noticed in an article that Commissioner Bradford wrote that I reviewed before these proceedings, he said, trying to keep track of how that money disappears into the balance sheet of a utility structure that is highly diversified is nigh onto impossible.

My argument would be, it is sort of irrelevant really in the direct sense to trace the cash. If the cash is being used for utility investment purposes, which in my mind would be the minimum purpose it should be used for, then it is freeing up cash that the company has on the other side of the ledger to go into diversified activities. Or it may well, in fact, not have any utility capital structures that are needed in investment, and therefore, the cash can go directly out to diversified areas.

So my comment to that is, you just simply cannot say that the money is not available. It may not be available in the cleanest and most direct form; that is, this \$500 million that we got from this kitty of excess tax reserves has been used to buy this drug store. But I am convinced that the overall effect is the same.

Mr. DORGAN. If you all feel so strongly about this, where were you during the public debate on 203(e) during the 1986 Tax Reform Act? No one heard from you.

Mr. SADLER. I was in Oregon fighting with the company.

Mr. DORGAN. Ms. Caplan.

Ms. CAPLAN. Unaware that there was such a debate going on, it was not in any notice of hearing that we were certainly aware of. We were very much involved in the debate on the overall tax bill. I put together personally an environmental panel to testify before the Ways and Means Committee. We submitted other testimony. As I said earlier, we are very much in support of the committee's efforts.

Mr. DORGAN. Mr. Cooper.

Mr. COOPER. We were vigorously involved in the effort to get that tax bill through, primarily because we saw it as a cost reducing or price reducing consumer aspect. And we were not aware of a public debate on 203(e).

Mr. DORGAN. Were you aware of 203(e)?

Mr. COOPER. I was not aware of—

Mr. DORGAN. There is no shame in admitting that.

Mr. COOPER. No, I was not. I did work the issue. We did meet on the general issue—we met with staff on the general issue of utility taxes. And frankly, we think the overall body of taxes that came out of that bill is a powerful step in the right direction. And again, primarily it exposes them to greater discipline in their access to and use of funds.

Mr. DORGAN. I might point out that there are some changes that I feel are necessary in the 1986 act; this one. I am supporting another change dealing with contributions in aid of construction, incidentally, which most of the utility industry wants, because I think it is necessary to change.

We did a lot of things in the 1986 Tax Reform Act that we need to correct. It was the most significant tax reform effort in this century, in my judgment. When you do that amount of work in the short time that we did it, you are going to want to make some adjustments down the road. And I think some adjustments perhaps you consumer groups will support and others you will oppose. The same would be true of the utility industry and American business. Some they will support, some they will oppose.

Any further comments the members of the panel wish to make? Mr. Cooper.

Mr. COOPER. I did not get a chance to respond to your question on that fairly earned rate of return and let me do whatever I want with it, because I mentioned it in my testimony.

One, these taxes are not part of that fairly earned rate of return. They are a bit of a gimmick that was put into the Tax Code.

And second of all, in respect to accounting, if executives of a diversified company devote 25 percent of their time to their unregulated businesses but only bill 10 percent of it, is that a fairly earned rate of return? There is a subsidy there. If employees are trained at the expense of utility ratepayers, then cherry-picked into the unregulated entity, then there is a subsidy there. And those kinds of charges have certainly been made by the staffs of both the New York and California Public Utility Commissions.

So that simple authorized rate of return can be a very elusive figure which hides a great deal of unfair rates of return which are, in essence, ratepayer dollars gotten under false pretext and used, therefore, unfairly to diversify.

Mr. DORGAN. Thank you very much. The subcommittee wishes to thank all of the members of the panel for your excellent testimony. Your entire statements will be made a part of the permanent record. We appreciate you being with us today.

Next the subcommittee will call Daniel Bell, the American Gas Association and Interstate Natural Gas Association, senior vice president of Columbia Gas Systems; Arthur Andersen & Co., Leonard Kujawa, partner; Deloitte Haskins & Sells, Emil Sunley, director of tax, national affairs office; and Edison Electric Institute, Samuel Huntington, president and chief executive officer, New England Electric System.

Gentlemen, we thank you for being present today at this subcommittee hearing. I would ask that you summarize your statements. We have a 5-minute light. We will include your entire statements in the permanent hearing record. We will begin with Mr. Daniel Bell, senior vice president, Columbia Gas Systems Service Corp., testifying on behalf of the American Gas Association and Interstate Natural Gas Association. Mr. Bell.

STATEMENT OF DANIEL L. BELL, SENIOR VICE PRESIDENT, COLUMBIA GAS SYSTEM SERVICE CORP., ON BEHALF OF AMERICAN GAS ASSOCIATION AND INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

Mr. BELL. I am accompanied today by John Faircloth, the vice president of taxes of our company.

I would like to point out, if I may initially, that the excess deferred tax figures of \$121 million shown for Columbia on the chart that we are looking at and on the testimony of NARUC is vastly overstated. The correct figure is \$54 million, rather than the \$121 million. I request permission to put that in the record.

Mr. DORGAN. Without objection.

Mr. BELL. I would also like to make another point which should be clarified at the outset, that not all regulatory bodies support the flowthrough principles contained in H.R. 1049. In 1981, in an order relating to the Columbia Gas System, the Federal Energy Regulatory Commission unanimously issued Order No. 144, where they firmly supported the theory of tax normalization. FERC continues its unqualified support of normalization.

AGA and INGAA oppose enactment of H.R. 1049 for the following reasons. Current law relating to this question of excess deferred taxes is an extension of the concept of normalization. It provides for rate stability for utility customers, since the tax benefit is shared among ratepayers over time. The flowthrough of these excess deferred taxes to current customers more rapidly than current law specifies would increase the rate base on which utilities are entitled to earn a profit, and would, therefore, skew the benefits unequally in favor of current customers at the expense of future customers who will also bear the cost of this existing asset.

Current law also promotes protection for current and future customers through ratemaking principles that produce rate stability. Calculations that have been made by the gas industry and which are included as exhibits in my written testimony illustrate the stability and rates that customers would experience if current law were left intact, as well as the interaction of excess deferred tax credits and ratemaking offsets to the credits.

The calculations reveal a trend that demonstrates two of the benefits that residential customers will realize if section 203(e) of the 1986 Tax Reform Act were left intact. One, customers will receive a greater benefit over time under current law than if H.R. 1049 were enacted. And two, the inequity of forcing future customers to subsidize the credits received by beneficiaries of H.R. 1049 would be avoided.

The second point I want to make is that H.R. 1049 would allow State regulatory bodies to require excess deferred taxes to be flowed through to customers on a very rapid schedule. In such circumstances, regulated companies would have to refinance the portion of their capital assets currently by excess tax deferrals through the issuance of either debt or stock.

In essence, H.R. 1049 would cause the low-cost source of internal capital to be replaced, perhaps immediately, by more expensive external financing arrangements. This newly incurred external financing cost would necessarily increase utility rates to a level

higher than would otherwise be the case if current law was left in place.

My third point is that the natural gas industry believes that it is desirable to structure tax policies so that regulated and nonregulated industries are treated more or less equally. For nonregulated industries, the reduction in corporate tax rates from 46 to 34 percent effectively converts a portion of deferred taxes into equity, since these excess deferred taxes will not be required to meet future tax liabilities. Thus the rate reduction automatically refinances existing assets with new equity capital.

For regulated companies, in contrast, deferred taxes would not be converted to equity capital under either current law or H.R. 1049. Both would require the same amount of excess deferred taxes to be credited to ratepayers. No excess deferred taxes would be retained by the regulated company.

We agree that excess deferred taxes should be used for the benefit of consumers. However, unlike nonregulated companies, regulated companies would be forced to refinance assets if excess deferred taxes were credited to customers on an accelerated basis.

The 1986 Tax Reform Act provides a better simulation of the tax treatment accorded nonregulated companies by allowing regulated companies to avoid near term refinancing costs for that portion of their capital assets currently financed by excess tax deferrals, while ensuring an orderly crediting of these deferrals to customers.

My fourth point is that the gas industry believes that the provision of the TRA that required excess deferred taxes to be normalized was an appropriate expression of tax policy because it assures uniformity among ratepayers. Without this requirement, State regulatory authorities could require crediting of excess deferred taxes to customers over various periods or all at once.

In conclusion, we believe that the uniform application of the benefits of a reduction in Federal tax rates was appropriately provided in the 1986 Tax Act. We are, after all, discussing Federal tax law. Federal tax law should apply uniformly in all 50 States. The uniform application of Federal tax law with respect to deferred taxes was provided for in TRA and should not be overturned.

Thank you, sir.

[The statement of Mr. Bell follows:]

TESTIMONY OF
 DANIEL L. BELL
 SENIOR VICE PRESIDENT,
 COLUMBIA GAS SYSTEM SERVICE CORPORATION
 ON BEHALF OF THE
 AMERICAN GAS ASSOCIATION, AND
 INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA
 BEFORE THE
 SUBCOMMITTEE ON SELECT REVENUE MEASURES
 COMMITTEE ON WAYS AND MEANS
 ON H.R. 1049
 THE UTILITY RATEPAYER REFUND ACT OF 1987
 December 14, 1987

INTRODUCTION

The American Gas Association (A.G.A.) is a national trade association comprising nearly 300 natural gas distribution and transmission companies. Together, these companies serve nearly 85 percent of all gas utility customers and account for more than 80 percent of all gas end-use sales. The Interstate Natural Gas Association of America (INGAA) is a national trade association comprising member companies which account for over 90 percent of all natural gas sold in interstate commerce and subject to the jurisdiction of the Federal Energy Regulatory Commission as mandated by provisions of the Natural Gas Act (NGA; 15 U.S.C. 717 *et. seq.*) and the Natural Gas Policy Act (NGPA; 15 U.S.C. 3301 *et. seq.*).

A.G.A. and INGAA oppose enactment of the Utility Ratepayer Refund Act of 1987, H.R. 1049. The bill would repeal section 203(e) of the Tax Reform Act of 1986 (TRA) and, consequently, place the responsibility in the hands of regulatory commissions to determine the periods over which refunds of excess deferred taxes will be distributed to customers. Both A.G.A. and INGAA are opposed to repeal or substantive change to the carefully balanced normalization provisions which were included in section 203(e) of the TRA. These provisions provide for a fair and rational return of the excess deferred taxes to the customers of distribution companies and pipelines.

The enactment of H.R. 1049 would fail to produce a net economic benefit for ratepayers and yet, at the same time, would place an unnecessary and unintended financial burden upon regulated natural gas companies. By repealing section 203(e) of the TRA, the bill would unravel a carefully balanced compromise between ratepayer and utility interests that serves to avoid this result. The natural gas industry also believes that reversal of established federal tax policy governing the regulatory treatment of book-tax differences would produce several undesirable side-effects. For example, by vesting authority in local regulatory bodies, H.R. 1049 would jeopardize the uniformity presently required by the Internal Revenue Code with respect to the return of excess deferred taxes to utility customers and risk inconsistent treatment of ratepayers over time. This legislation would also likely increase the cost of capital to the regulated natural gas industry and, by producing higher utility rates charged to customers in years following the return of excess deferred taxes, reduce the net cost benefit to ratepayers. As a result, the natural gas industry contends that the benefit conferred upon ratepayers by section 203(e) exceeds that which may be produced by H.R. 1049.

REVERSAL OF FEDERAL TAX POLICY

H.R. 1049 would repeal section 203(e) of the TRA and, in so doing, reverse long-standing tax policy governing the

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treatment of deferred taxes by regulated utility taxpayers. Section 203(e) requires excess deferred taxes attributable to depreciation on public utility property to be "normalized," or returned to the ratepayers over the depreciable lives or remaining depreciable lives of the assets which created the tax deferral. Deferred taxes arise when tax depreciation deductions exceed regulatory depreciation expense. This results in higher regulatory revenues because the taxes "collected" in rates are computed on the basis of regulatory depreciation expense, whether lower or higher than the tax depreciation deductions claimed each year. The excess occurs because taxes were collected from customers at a 46 percent rate but will be payable at only a 34 percent rate after the TRA becomes fully effective.

Normalization of these deferred taxes attributable to depreciation on public utility property is an accepted provision of federal tax policy for the regulated public utility industry and has been embodied in the Internal Revenue Code since 1969. At that time, the normalization of accelerated depreciation was adopted as a matter of federal policy so that regulated companies could avail themselves of and retain the same tax deferrals available to other, non-regulated companies. This federal policy allows regulated companies to invest tax deferrals attributable to accelerated depreciation in new plant and equipment. The natural gas industry has invested these amounts in the manner encouraged by the federal policy.

The ratepayer has benefitted from the use of this property since ratebase (upon which a regulated company's rate of return is paid through rates) was reduced by a corresponding amount. If the return of excess deferred taxes is now to be carried out in congruity with the long-standing federal policy, these amounts should be returned to ratepayers over the remaining life of the property that originally generated the tax deferral. Section 203(e) of the TRA follows this principle; it adheres to established federal tax policy and assures that the benefit attributable to the return of the excess deferred taxes will be shared by the same ratepayers over time as originally contemplated under normalization. Consequently, the isolated repeal of section 203(e) at this juncture involves more than the mere refund of an overcollection; rather, it constitutes a sweeping reversal of policy unwarranted by the equities of this proposal.

RATE STABILITY/PROJECTED REFUNDS

The normalization of excess deferred taxes provides rate stability for utility customers since the tax benefit is shared among ratepayers over time. Deferred taxes reduce rate base. If all excess deferred taxes previously used to reduce rate base were refunded in a single year, the rate base would increase, and rates charged to customers would increase significantly as a result. This action would produce a wide swing in the utility bills of customers. Normalizing excess deferred taxes, on the other hand, allows for the gradual reduction of deferred taxes and, consequently, a gradual increase in rate base. This policy provides long term stability in utility bills, which promotes the interests of our customers in the long run.

Section 203(e) also promotes protection for current customers through rulemaking principles that produce stability. Because deferred taxes are used to reduce rate base, current customers, in essence, receive a rate reduction as long as excess deferred taxes remain on the regulatory books of gas companies. This is equivalent to a return on money that customers are "deemed to have lent the company" even though it is technically the government that

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provided the capital incentives to the company.

The attached exhibits illustrate the stability in rates that customers would experience if section 203(e) were left intact as well as the interaction of excess deferred tax refunds and ratemaking offsets to the refunds. Note that these exhibits estimate the gross refunds of local distribution companies (LDCs) and interstate pipelines. The exhibits also show the rate effect (i.e., rate increase) attributable to removing excess deferred taxes from regulated books of account. This rate effect is subtracted from the gross refund to show the true effect that refunding excess deferred taxes will have on residential customers ("Refund Less Increase in Rates").

The exhibits reveal a trend that demonstrates two of the benefits that residential customers will realize if section 203(e) were left intact: (1) customers will receive a larger refund over time than if H.R. 1049 were enacted; and (2) the inequity of forcing future customers to subsidize the refunds received by beneficiaries of the Dorgan bill would be avoided.

Under Exhibit A, refunds would be normalized and paid to residential customers over the remaining life of the assets that gave rise to the excess deferred taxes (the remaining life is assumed to be 15 years). This would allow a net average nationwide refund of \$16.47 to be paid to residential natural gas customers. Exhibit B shows that such refunds would drop to \$7.36 if H.R. 1049 were enacted and regulatory commissions ordered the refunds to be paid over a five year period. Even worse for customers, as shown in Exhibit C, these refunds would drop to only \$3.87 if they were flowed through to customers in just one year. The conclusion that the natural gas industry draws is that the enactment of H.R. 1049 would promote benefits for a limited group of customers by paying them refunds. The benefit that some customers would receive would cause succeeding customers to bear the burden of future rate increases. While this may be attractive for customers with short-term interests, it should be very distasteful for customers with long-term interests. In contrast to H.R. 1049, retaining section 203(e) will allow customers to receive a larger net refund than they would receive under H.R. 1049. Thus, the more equitable procedure for customers would be to retain section 203(e) so that customers who must shoulder a portion of increased rates will also receive a portion of the refund of excess deferred taxes.

COST OF CAPITAL INCREASES

The cost of capital to a regulated public utility cannot be expected to remain constant in view of such a dramatic change in ratemaking. One of the purposes of accelerated tax depreciation is to allow the resulting tax deferrals to be used to finance capital investments. In effect, this allows companies to forego more costly external financing in favor of this source of internal capital. As a result, regulated companies can reduce rates charged to customers to the extent that tax deferrals are realized via accelerated depreciation. However, if the tax deferrals resulting from accelerated depreciation are required to be flowed through, regulated entities would not be able to avail themselves of this source of internal financing. Any consequential increase in financing costs would necessarily have to be reflected in higher rates charged to customers.

Similarly, H.R. 1049 would allow regulatory bodies to require excess deferred taxes to be flowed through to customers in the form of immediate refunds or lower rates. In such circumstances, regulated companies would be required to refinance the portion of their capital assets currently

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In such circumstances, regulated companies would be required to refinance the portion of their capital assets currently financed by the excess tax deferrals. In this regard, it is particularly important to note that excess deferred tax reserves are not cash reserves. Rather, such reserves are an accounting entry. A rapid refund of excess deferred taxes would require that most companies either issue more debt or raise more capital. In essence, H.R. 1049 would cause the low-cost source of internal capital to be replaced, perhaps immediately, by more expensive external financing arrangements. This would be contradictory to the intent of Congress with respect to allowing accelerated depreciation to finance capital investments. If section 203(e) were repealed, the newly incurred external financing costs would increase utility rates to a level higher than would otherwise have been the case.

This scenario, and its effects on the public, are discussed in an article by Thomas Horst and Emil Sunley, The Case for Normalizing the Excess Tax Reserves of Public Utilities, Tax Notes (June 29, 1987). The authors point out that if investment-related tax deferrals were flowed through by utilities to customers, the rates charged to customers would fluctuate. On the other hand, if these deferrals are normalized, utility rates are stabilized. By following the normalization principle, lower capital costs are obtained by the utility because: (1) cash flow is stabilized, allowing the utility's securities to have a lower risk factor, and (2) the utility's needs to raise capital in external markets are diminished.

Horst and Sunley conclude that the net cost to the public of returning excess deferred taxes to customers, in present value terms, is the same under both normalization and flow through, provided the cost of capital is the same under both practices (emphasis added). As noted above, however, normalization reduces a utility's need to raise new capital. By contrast, flow through of excess deferred taxes would increase the cost of capital. Because of its lower cost of capital, normalization would result in a lower net cost to the public. Thus, although H.R. 1049 may bring accelerated refunds to utility customers, it would produce an ephemeral benefit for which ratepayers eventually pay a higher price than would be paid if section 203(e) were left intact.

DISPARATE EFFECTS ON REGULATED AND UNREGULATED INDUSTRIES

The natural gas industry believes that it is desirable to structure tax policies so that regulated industries and unregulated industries are treated equally. For nonregulated industries, the reduction in corporate tax rates from 46 percent to 34 percent may not affect the prices of products. The choice is solely within the discretion of the taxpayer. The taxes that were previously deferred may continue to finance capital assets. In effect, the tax rate reduction converts a portion of deferred taxes into equity for a nonregulated company since these excess deferred taxes will not be required to meet future tax liabilities. Assuming the tax rate reduction does not affect prices, it automatically refinances existing assets with new equity capital.

For regulated companies, in contrast, deferred taxes would not be converted to equity under either normalization or flow-through. Both normalization and flow-through would require the same amount of excess deferred taxes to be returned to ratepayers. No excess deferred taxes would be retained by the regulated company. However, unlike non-regulated companies, regulated companies would be forced to refinance assets if excess deferred taxes were flowed

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through. Normalization provides a better simulation of the tax treatment accorded non-regulated companies by allowing regulated companies to avoid requiring near-term refinancing of that portion of capital assets currently financed by excess tax deferrals.

DISTRIBUTION OF REFUNDS

Total deferred income taxes for the gas industry, as of the end of 1986, were \$8.365 billion. Of this total, we estimate that approximately \$1.7 billion represents excess deferred taxes that would be affected by H.R. 1049.

Of this \$1.7 billion, a relatively small portion -- approximately one-third -- would be returned to residential customers. The remaining two-thirds would be refunded to industrial, commercial, and other large-volume customers. Stated differently, approximately \$1.1 billion of the gas industry's excess deferred taxes would be allocable primarily to industrial and commercial customers. If the purpose of H.R. 1049 is to return excess deferred taxes to residential customers, as its sponsors claim, these figures reveal that the bill would be only modestly beneficial with respect to gas industry residential customers.

Rather than targeting the refund of excess deferred taxes to individuals, the bill would result in only about one-third of the excess deferred tax reserve accruing to the benefit of these residential customers. Consequently, the repeal of section 203(e) of the TRA would amount to overturning federal tax policy so that two-thirds of excess deferred taxes would be returned to industrial and commercial firms. We note that the immediate return of these taxes would not only be contrary to existing federal tax policy, but it would also represent a double benefit for industrial and commercial firms. That is, these firms, unlike regulated industries, will not be obligated to return excess deferred taxes to their customers. They could enjoy the luxury of receiving benefits from both the Federal Government and private utilities. The benefit from the Federal Government would be that such firms can retain the excess deferred taxes that they have accumulated. They would not be required to return these taxes to their customers. The benefit from private utilities is that such firms would likely receive from regulated industries on an accelerated basis the amount of excess deferred taxes that regulated industries would be required to return to customers if section 203(e) is repealed. In essence, these industrial and commercial firms would benefit twice -- first as a result of the enactment of the TRA and second as a result of the repeal of a part of the TRA.

UNIFORM TREATMENT OF RATEPAYERS

The gas industry believes that the provision of the TRA that required excess deferred taxes to be normalized was an appropriate expression of tax policy because it assures uniformity among ratepayers in the application of federal tax laws on this issue. Without this requirement, regulatory authorities could require repayment of excess deferred taxes to customers over various periods or all at once. Under these circumstances, the normalization requirements would be compromised and result in the very perceptions of unequal tax treatment that the TRA was designed to eliminate.

The corporate tax rate reduction enacted in 1978, from 48 percent to 46 percent, provides a good illustration of the disparity in methods of treating excess deferred taxes that may be employed by regulatory bodies if section 203(e) is repealed. Excess deferred taxes created by that tax rate reduction were not refunded at all by four states. At least

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10 states required these taxes to be returned to customers over the remaining life of property to which excess deferred taxes were attributable. At least 23 other regulatory commissions required excess deferred taxes to be returned to customers over periods ranging from one year to 10 years.^{1/}

The gas industry believes that this wide disparity in regulatory treatment was properly avoided in the TRA. The appropriate tax policy of ensuring uniform application of federal tax law was provided in the TRA and should not be overturned now.

CONCLUSION

The natural gas industry opposes the enactment of H.R. 1049. According to our projections, the net refund that customers will receive over time will be much larger if section 203(e) of the TRA is retained than if H.R. 1049 is enacted. By accelerating refunds and causing subsequent rate increases, H.R. 1049 would place an inequitable burden on customers who are served by a utility company after all accelerated excess deferred taxes have been refunded.

Moreover, H.R. 1049 represents a measure that would begin to chip away at the carefully balanced principles of normalizing tax savings for utilities. Retaining section 203(e) as a part of the tax law will allow utilities to provide continuity in the rates charged to customers.

This continuity will allow utilities to maintain a lower risk factor for their securities and reduce their need to raise capital in external capital markets. The instability in rates that might result if H.R. 1049 were enacted would cause utilities to lose these two benefits of stable rates and cause the costs of raising capital to increase. Such an increased cost of raising capital would produce a higher net cost that would be incurred by the public. Hence, the purported customer benefits of H.R. 1049 would be illusory. From a policy perspective, this proposal does not warrant overturning the carefully crafted principle of normalization. Retaining normalization of excess deferred taxes will allow utilities to return these taxes to customers under a reasonable schedule that will work to the benefit of both the customers and the utilities. Section 203(e) should be retained.

1. Kiefer, Donald W., The Tax Reform Act of 1986: The Effects on Public Utilities, Congressional Research Service, March 18, 1987.
2. Id. at CRS-6.
3. Gas Facts, The American Gas Association, Arlington, Virginia, 1986, p. 153.
4. Foley, Michael and Rodgers, Paul, Regulation of Public Utilities Under the Tax Reform Act of 1986, National Association of Regulatory Utility Commissioners, Washington, D.C., January 28, 1987, p.6.

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Exhibit ASIMULATED NORMALIZATION METHODOLOGY
REVERSE SOUTH GEORGIA - 15 YEARS

	<u>LDC Refund</u>	<u>Pipe- Line Refund</u>	<u>LDC & Pipe- Line Refund</u>	<u>Rate Effect of LDC Refunds</u>	<u>Rate Effect of Pipe- Line Refunds</u>	<u>Total Rate Effect</u>	<u>Refund Less Increase In Rates</u>
Year 1	1.50	.64	2.14	(.17)	(.07)	(.24)	1.90
Year 2	1.50	.64	2.14	(.32)	(.14)	(.46)	1.68
Year 3	1.50	.64	2.14	(.46)	(.20)	(.66)	1.48
Year 4	1.50	.64	2.14	(.59)	(.25)	(.84)	1.30
Year 5	1.50	.64	2.14	(.71)	(.30)	(1.01)	1.13
Year 6	1.50	.64	2.14	(.81)	(.34)	(1.15)	.99
Year 7	1.50	.64	2.14	(.89)	(.38)	(1.27)	.87
Year 8	1.50	.64	2.14	(.96)	(.41)	(1.37)	.77
Year 9	1.50	.64	2.14	(1.00)	(.43)	(1.43)	.71
Year 10	1.50	.64	2.14	(1.02)	(.44)	(1.46)	.68
Year 11	1.50	.64	2.14	(1.02)	(.43)	(1.45)	.69
Year 12	1.50	.63	2.13	(.98)	(.42)	(1.40)	.73
Year 13	1.50	.63	2.13	(.90)	(.38)	(1.28)	.85
Year 14	1.50	.63	2.13	(.77)	(.32)	(1.09)	1.04
Year 15	<u>1.56</u>	<u>.63</u>	<u>2.19</u>	<u>(.38)</u>	<u>(.16)</u>	<u>(.54)</u>	<u>1.65</u>
	22.56	9.56	32.12	(10.98)	(4.67)	(15.65)	<u>16.47</u>

Exhibit BSIMULATED DORGAN PROPOSAL
ACCELERATED REFUND OF "EXCESS DEFERRED TAXES"
FIVE YEAR REFUND

	<u>LDC Refund</u>	<u>Pipe- Line Refund</u>	<u>LDC & Pipe- Line Refund</u>	<u>Rate Effect of LDC Refunds</u>	<u>Rate Effect of Pipe- Line Refunds</u>	<u>Total Rate Effect</u>	<u>Refund Less Increase In Rates</u>
Year 1	4.52	1.92	6.44	(.50)	(.21)	(.71)	5.73
Year 2	4.51	1.91	6.42	(.96)	(.41)	(1.37)	5.05
Year 3	4.51	1.91	6.42	(1.39)	(.59)	(1.98)	4.44
Year 4	4.51	1.91	6.42	(1.78)	(.75)	(2.53)	3.89
Year 5	4.51	1.91	6.42	(2.13)	(.90)	(3.03)	3.39
Year 6				(1.93)	(.82)	(2.75)	(2.75)
Year 7				(1.74)	(.74)	(2.48)	(2.48)
Year 8				(1.55)	(.66)	(2.21)	(2.21)
Year 9				(1.35)	(.57)	(1.92)	(1.92)
Year 10				(1.16)	(.49)	(1.65)	(1.65)
Year 11				(.97)	(.41)	(1.38)	(1.38)
Year 12				(.77)	(.33)	(1.10)	(1.10)
Year 13				(.58)	(.25)	(.83)	(.83)
Year 14				(.39)	(.16)	(.55)	(.55)
Year 15				<u>(.19)</u>	<u>(.08)</u>	<u>(.27)</u>	<u>(.27)</u>
	22.56	9.56	32.12	(17.39)	(7.37)	(24.76)	<u>7.36</u>

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Exhibit C

SIMULATED DORGAN PROPOSAL
ACCELERATED REFUND OF "EXCESS DEFERRED TAXES"
ONE YEAR REFUND

	LDC Refund 1 year	Pipe- Line Refund 1 year	LDC & Pipe- Line Refund	Rate Effect of LDC Refunds	Rate Effect of Pipe- Line Refunds	Total Rate Effect	Refund Less Increase In Rates
Year 1	22.56	9.56	32.12	(2.48)	(1.05)	(3.53)	28.59
Year 2				(2.31)	(.98)	(3.29)	(3.29)
Year 3				(2.15)	(.91)	(3.06)	(3.06)
Year 4				(1.99)	(.84)	(2.83)	(2.83)
Year 5				(1.82)	(.77)	(2.59)	(2.59)
Year 6				(1.65)	(.70)	(2.35)	(2.35)
Year 7				(1.49)	(.63)	(2.12)	(2.12)
Year 8				(1.32)	(.56)	(1.88)	(1.88)
Year 9				(1.16)	(.49)	(1.65)	(1.65)
Year 10				(.99)	(.42)	(1.41)	(1.41)
Year 11				(.83)	(.35)	(1.18)	(1.18)
Year 12				(.66)	(.28)	(.94)	(.94)
Year 13				(.50)	(.21)	(.71)	(.71)
Year 14				(.33)	(.14)	(.47)	(.47)
Year 15				(.17)	(.07)	(.24)	(.24)
	22.56	9.56	32.12	(19.85)	(8.40)	(28.25)	3.87

Summary Exhibit

AVERAGE REFUND PER RESIDENTIAL GAS CUSTOMER
UTILITY PLANT WITH 15 YEAR REMAINING LIFE

	<u>Simulated Dorgan One Year Refund</u>	<u>Simulated Dorgan Five Year Refund</u>	<u>Simulated Normali- zation Methodology (A)</u>
Year 1	28.59	5.73	1.90
Year 2	(3.29)	5.05	1.68
Year 3	(3.06)	4.44	1.48
Year 4	(2.83)	3.89	1.30
Year 5	(2.59)	3.39	1.13
Year 6	(2.35)	(2.75)	.99
Year 7	(2.12)	(2.48)	.87
Year 8	(1.88)	(2.21)	.77
Year 9	(1.65)	(1.92)	.71
Year 10	(1.41)	(1.65)	.68
Year 11	(1.18)	(1.38)	.69
Year 12	(.94)	(1.10)	.73
Year 13	(.71)	(.83)	.85
Year 14	(.47)	(.55)	1.04
Year 15	(.24)	(.27)	1.65
TOTAL	3.87	7.36	16.47

(A) Utilizing Reverse So. Georgia Method

Mr. DORGAN. Thank you, Mr. Bell.
Mr. Kujawa. Proceed, sir.

**STATEMENT OF LEONARD J. KUJAWA, PARTNER AND MANAGING
DIRECTOR, UTILITIES AND TELECOMMUNICATIONS PRACTICE,
ARTHUR ANDERSEN & CO.**

Mr. KUJAWA. My name is Leonard J. Kujawa. I am managing director of the utilities and telecommunications practice of Arthur Andersen & Co., independent public accountants. Two of my partners, Wesley Scheibel and Jay Price are with me here today. I am appearing as a representative of Arthur Andersen & Co., and not on behalf of any client or other organization.

Arthur Andersen & Co. are independent public accountants for about one-third of the U.S. electric and gas industry, and for a substantial portion of the telephone industry. As independent accountants, we believe the proper reporting to the public of financial information, including the effects of income taxes, is critically important.

The purpose of my statement is to set forth the reasons why I believe that the legislation introduced by the Honorable Byron Dorgan should not be enacted into law. Let me give the principal points of my prepared statement which has been submitted for the record.

The economic effect of the incentive of accelerated depreciation over straight line depreciation is, in effect, an interest-free loan from the U.S. Treasury to taxpayers, which has been granted by Congress when it postponed but did not forgive tax payments. Deferred income tax reserves recorded in corporate financial statements reflect these interest-free loans.

As a result of the Tax Reform Act of 1986, Congress forgave all taxpayers for a portion of this loan. Congress also set forth in section 203(e) of the act how the forgiveness of the loan to utility companies would be handled. Historically, Members of the House Ways and Means Committee and Congress have stated that the purpose of enacting accelerated tax depreciation was to provide funds for the modernization of plant and to increase employment, not to reduce utility customer rates in the short term.

I believe that where the ratemaking relates to tax incentives granted by Congress to achieve a particular objective, it is proper for Congress to deny the incentive to the taxpayer if the ratemaking prescribed is inconsistent with the intent of the incentive. Therefore, it is appropriate to set the limitation of section 203(e) so that congressional objectives can be achieved.

My second point is that repeal of section 203(e) would allow regulatory commissions to reflect the forgiveness of the loan as reduced customer rates in the short term. These reductions in utility revenues would lead to reduced taxable income, and therefore, reduced income tax payments to the U.S. Treasury by the utility industry.

We estimate that such reduced tax payments to the U.S. Treasury from the utility industry could be as high as \$10 billion depending on the extent to which the states cause an acceleration of the flowback of these excess reserves.

My third and final point is, certain regulatory commissions have, in prior years, reflected the loan itself rather than the interest-free benefit of the loan and reduced customer rates. This liability for the loan has not been recorded by the utility. In other words, there are no deferred taxes recorded for these loans in the financial statements of affected utility companies.

As a result, there is a significant multibillion dollar unrecorded liability for the repayment of these loans to the U.S. Treasury. Funds to repay these unrecorded loans must be collected from present and future customers over the related property life during the next 10 to 30 years.

Accordingly, if these deficiencies are reflected in rates over the life of the property, it would be consistent to reflect the effects of the excess recorded deferred tax reserves over the same period of time. To do otherwise would result in an immediate rate decrease followed by significant rate increases that would continue for many future years.

We estimate that in the aggregate, the unrecorded tax liability of electric companies alone exceeds this so-called excess deferred tax reserves. That is, the portion of the recorded liability to the U.S. Treasury that has been forgiven because of the reduction in tax rates.

With respect to electric companies, we estimate that the unrecorded tax liability exceeds \$12 billion. This amount exceeds by almost \$2 billion, that amount that has been quantified in a separate study by another party as the recorded excess tax liabilities arising because of the change in tax rates.

Reducing customer rates in one year because of the excess tax liabilities, as repeal of section 203(e) would permit, while increasing customer rates over the remaining life of the property when recorded tax liabilities are deficient, reminds me frankly of a child who devours his dessert before he must face his vegetables.

And that completes my statement, Mr. Chairman.

[The statement of Mr. Kujawa follows:]

STATEMENT
ON
PROPOSED REPEAL OF SECTION 203(e) OF THE
TAX REFORM ACT OF 1986
for submission to the
SUBCOMMITTEE ON SELECT REVENUES MEASURES
of the
HOUSE COMMITTEE ON WAYS AND MEANS
for
ARTHUR ANDERSEN & CO.
by
Leonard J. Kujawa
December 14, 1987

Introduction

My name is Leonard J. Kujawa and I am Managing Director of the Utilities and Telecommunications Practice of Arthur Andersen & Co., independent public accountants. Two of my partners, Wesley Scheibel, Director of our Utilities and Telecommunications Tax Practice, and Jay Price, Director of our Utilities and Telecommunications Ratemaking Practice, are with me today.

I am appearing as a representative of Arthur Andersen & Co., and not in behalf of any client or organization. The positions that I am presenting are solely those of Arthur Andersen & Co.

Arthur Andersen & Co. are independent public accountants for about one-third of the U.S. electric and gas industry and for a substantial portion of the telephone industry. As independent public accountants, we believe that the proper reporting to the public of financial information, including the effects of income taxes, is extremely important. With respect to public utility companies, the reported financial information is affected to a significant degree by the ratemaking procedures applied to such utilities by regulatory commissions. Therefore, we are vitally concerned about the matter before this Committee.

We have a long history of encouraging the proper accounting for, and ratemaking treatment of, the effects of income taxes. Arthur Andersen & Co. partners have appeared extensively before Federal and state utility regulatory commissions with respect to the proper accounting and ratemaking treatment of income taxes. A predecessor of mine as Managing Director, Richard Walker, appeared before the House Committee on Ways and Means in 1969 when it was first considering legislation to provide for consistency between the intent of Congress in granting tax incentives and the ratemaking for such incentives. The resulting legislation, the Tax Reform Act of 1969, as well as subsequent tax legislation, contained provisions to achieve such consistency.

Purpose of This Statement

The purpose of this statement is to set forth the reasons why I do not believe that the legislation introduced by the Honorable Byron Dorgan (HR 1049) should be enacted into law. Congressman Dorgan's bill provides that Section 203(e) of the Tax Reform Act of 1986 be repealed. Section 203(e) essentially provides that the normalization reserves for deferred taxes which the Internal Revenue Code requires that utility companies establish cannot be reduced and thereby used to reduce customer rates more rapidly than over the lives of the property giving rise to such reserves. These normalization reserves were provided at tax rates that now exceed the current corporate tax rate set in the Tax Reform Act of 1986. Section 203(e) permits the resulting "excess" reserves to be used to reduce customer rates over the life of the related

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property. This provision is consistent with the longstanding Congressional intent that property-related tax incentives be spread over the life of such property.

In summary, the principal points that I will make are:

1. These deferred tax (normalization) reserves reflect the economic effect of the interest free loans granted by Congress when it postponed but did not forgive tax payments. As a result of the Tax Reform Act of 1986, Congress forgave all taxpayers for a portion of the loan, and Congress also set forth in Section 203(e) of that Act how the forgiveness of the loan to utility companies would be handled. Historically, Congress has provided how the benefits of the property-related tax incentives it has granted are to be allocated, consistent with the intent of the legislation granting the incentive - that is, over the life of the related property giving rise to the incentive. Section 203(e) is consistent with this Congressional practice.
2. Repeal of Section 203(e) would allow regulatory commissions to reflect the forgiveness of the loan as reduced customer rates in a period as short as one year. These reductions in utility revenues would lead to reduced taxable income and, therefore, reduced income tax payments. We estimate that such reduced tax payments to the U.S. Treasury could be as high as \$10 billion.
3. Certain regulatory commissions have in prior years reflected the loan itself, rather than the interest-free benefit of the loan, in reduced customer rates, and the liability for the loan was not recorded by the utility. As a result, there is a significant multi-billion dollar unrecorded liability (deficiency) for the repayment of these loans to the U. S. Treasury. Funds to repay these unrecorded loans must be collected from present and future customers over the related property life during the next 20 to 30 years. Just as these deficiencies are reflected in rates over the life of the property, it would be consistent to reflect the effects of the "excess" recorded deferred tax reserves over the lives of the related property. We estimate that the unrecorded liability of electric companies exceeds in the aggregate recorded "excess" deferred tax reserves (the portion of the recorded liability to the U. S. Treasury that has been forgiven).

Background on Applicable Tax Incentives

In 1954, Congress rewrote the Internal Revenue Code. Among the provisions included in the rewritten Code was the right of all taxpayers to claim depreciation allowances that were based on other than a straight-line method, which was and still is the method generally used for financial reporting purposes. Previously, the tax depreciation deduction had largely been based on dividing the tax basis of the property by its estimated useful life. For example, if the tax basis were \$1,000 and the estimated useful life were 10 years, the tax depreciation deduction each year would be \$100. The 1954 Code provided methodologies (double declining balance, sum-of-the-years' digits, etc.) that allow the taxpayer to deduct the same amount of depreciation in total over the life of the property, but to deduct a greater amount of tax depreciation in earlier years and offsetting lower amounts in later years. In my prior example, while the aggregate amount of the tax depreciation deductions would still be \$1,000, the annual amount allowed in the earlier years would be greater than \$100 and the annual amount allowed in later years would be less than \$100. Subsequent additions and revisions to the Internal Revenue Code included the (a) Asset Depreciation Range (ADR) provisions of 1971, which reduced tax lives, (b) the Accelerated Cost Recovery System (ACRS) in the Economic Recovery Tax Act of 1981, which continued to allow acceleration of tax deductions, and (c) the Tax Reform Act of 1986, which reduced but did not eliminate the acceleration. Thus, the acceleration of tax deductions over that allowed on the straight-line basis has been retained, and more depreciation continues to be allowed in the earlier years and less in the later years of the property life of all taxpayers.

Congress stated in the Committee Reports accompanying these pieces of legislation that the incentive of accelerated depreciation was being granted by Congress to all taxpayers for purposes of encouraging the modernization of the nation's industrial facilities and improving productivity. The economic effect of the incentive of accelerated tax depreciation over straight-line depreciation is an interest-free loan from the U.S. Treasury to the taxpayer. This loan, measured by the tax rate times the difference between accelerated depreciation and straight-line depreciation, builds up in the earlier years of a property's life and then is repaid in the later years. It is important to recognize that the only benefit of accelerated depreciation to taxpayers is an interest-free loan provided by the postponed, but not forgiven, tax payments. The principal of the loan has to be repaid. Because Congress has made these interest-free funds available during the life of the property, less outside financing is required, thereby reducing financing costs. These reduced financing costs are realized over the life of the property. This benefit granted by Congress is available to all taxpayers. In the case of regulated utilities, a majority of regulatory commissions adopted ratemaking procedures which, as I will explain, reduced customer rates by these reduced financing costs.

The drop in the corporate income tax rate in the Tax Reform Act of 1986 from 46% to 34%, has the effect on all taxpayers of reducing the loan that must be paid back to the U.S. Treasury. Congress has essentially forgiven a portion of the interest free loans outstanding at December 31, 1986. The question that Section 203(e) addresses is how the economic effect of this loan forgiveness granted by Congress is to be handled for ratemaking purposes so as to be consistent with the intent of Congress.

Congressional Provisions to Achieve Consistency

In 1954, Congress placed no limitations on utility taxpayers as to the use of the funds made available through tax incentives such as accelerated depreciation. During the years following 1954, certain public utility commissions took the view that the loan itself rather than the time value of the interest free loan should be passed on to ratepayers. The presumption generally was that later ratepayers could repay the loan out of funds generated from subsequent loans. Passing the principal of the interest-free loan to customers is referred to as "flow-through" ratemaking.

Let me add here that the majority of the regulatory commissions did not engage in this "Ponzi" game and instead recognized that accelerated depreciation deductions created interest-free loans that had to be repaid. These commissions generally passed on the real economic benefit of these loans - their interest-free feature - by requiring that the accumulated deferred income tax balances (the loan to be repaid) be deducted from the utility company's rate base on which it was entitled to earn a return. This type of ratemaking is more beneficial and equitable to customers in the long run and is consistent with the Congressional intent of reducing financing costs over the life of the property.

During hearings in 1969 before the House Ways and Means Committee, then Chairman Mills reiterated that the purpose of granting the tax incentive of accelerated depreciation was to encourage plant modernization, not to provide for immediate reductions in customer rates. To ensure that the tax incentives that it granted were being utilized as Congress intended, Congress, in 1969 (and in all subsequent legislation related to accelerated tax depreciation deductions, including Section 203(e)), set forth standards that if violated would cause the utility company to lose the right to deduct accelerated rather than straight-line depreciation - in other words, lose the right to receive these interest-free loans from the U.S. Treasury.

Therefore, Congress decided in 1969 to put a stop to further flow-through of the loan principal by stating that a utility company could not use accelerated tax depreciation in the future if it were to become subject to flow-through ratemaking. An exception was provided for utilities which had been previously subject to flow-through ratemaking. In 1981, Congress eliminated this grandfather provision related to utilities subject to flow-through ratemaking prior to 1969. As a result, at present all utilities would lose the right to use accelerated tax depreciation deductions if they are subject to flow-through ratemaking with respect to the related property. There are,

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however, still significant lingering effects of prior flow-through ratemaking which I will discuss later.

It is important to note that Congress did not require the regulatory commissions to follow any particular form of ratemaking. Rather, Congress indicated that if a regulatory commission were to follow ratemaking procedures with respect to tax incentives that created economic results contrary to the intent of Congress in granting such incentives, those incentives would no longer be available to the taxpayer subject to such ratemaking procedures. The practical effect, of course, was that regulatory commissions recognized the benefit to customers of these interest-free loans and did not want to do anything that would jeopardize the right of the utility companies to receive them.

Each time that Congress has considered the tax incentive provided by accelerated tax depreciation subsequent to 1969, it has continued or strengthened the provisions against flowing through the principal of the loan to customers. Section 203(e) of the Tax Reform Act of 1986 is a continuation of the practice of placing limitations on tax incentives granted to regulated utilities as a means of forestalling ratemaking that would create economic effects inconsistent with these tax incentives. In Section 203(e), Congress essentially is stating that it believes that the benefits of the forgiveness of a portion of the interest-free loan because of the corporate tax rate reduction should be spread over the life of the property because that was the period over which the benefits of the interest-free loan were intended to be realized.

It is my view that it is appropriate for Congress to include these special provisions in the tax law in order to ensure that tax incentives granted are used as Congress intended.

Reduction in Tax Payments to the U.S. Treasury

Congress was also concerned in 1969 that without any limitations on the use of accelerated tax depreciation, more and more regulatory commissions would opt for using the loan principal, rather than the reduction in financing costs, to reduce customer rates. Without any provisions to deter a movement toward flow-through of the loan itself as reductions in customer rates, there would be very adverse effects on U.S. Treasury revenues. Furthermore, because of the "tax-on-tax" effect,^{1/} the U.S. Treasury would lose revenues equivalent to an amount much greater than the tax effect of the accelerated depreciation deductions themselves.

Today, there would be an immediate significant effect on tax payments to the U.S. Treasury if Congress were to remove the limitations in Section 203(e) on immediate rate reductions for the partial forgiveness of interest-free loans. The National Association of Regulatory Utility Commissioners (NARUC) has estimated that the so-called "excess" deferred taxes for electric, gas and telephone companies are approximately \$19 billion as of the end of 1986. Based on this \$19 billion figure, the impact on payments to the U.S. Treasury, if that amount were to be reflected in customer rates in one year, would be approximately \$10 billion.^{2/}

^{1/} Over and above the reduction in tax payments because of accelerated tax depreciation, there is a further reduction in tax payments under flow-through ratemaking. Because flow-through ratemaking ignores the provisions for deferred tax liabilities, revenue requirements are reduced. This reduces taxable revenues, which, in turn, gives rise to an additional reduction in tax payments. This pyramiding effect results from the fact that revenue requirements under utility ratemaking include reimbursement of income tax costs. To be reimbursed for \$1.00 of income tax costs, the amount of reimbursement must be \$1.52 (at a 34% tax rate) because the reimbursement itself is subject to tax.

^{2/} This is based upon grossing up the \$19 billion amount for the "tax-on-tax" effect to \$29 billion and computing the reduction in tax payments to the U.S. Treasury as 34% of \$29 billion.

Furthermore, ratepayers would be adversely affected after an immediate rate reduction because their future rates would be higher than they would be if Section 203(e) were retained. This is because the recorded deferred income tax liabilities that were previously used to reduce rate base (thereby reducing financing costs included in customer rates) would no longer be available. Without the protection of Section 203(e), utilities could be faced with immediately financing the replacement of these interest-free loans in today's uncertain market at the current cost of money. After the one-time rate reduction, the cost of financing the replacement loans will significantly increase customer rates in every year thereafter.

Unrecorded Deferred Tax Liabilities

Where regulatory commissions have allowed the principal of the loans, rather than the interest-free component, to be flowed through to customers in reduced rates, present accounting principles do not require the liability to the U.S. Treasury to be recorded on the balance sheet of utility companies.

We have made a survey of electric companies and determined that based upon footnote disclosures contained in 1986 annual reports, the aggregate unrecorded tax liabilities of electric utilities is a multi-billion dollar amount, which may well exceed the amount that would be considered "excess" recorded deferred tax liabilities. These unrecorded tax liabilities related to flow-through ratemaking are generally now being recovered over the remaining lives of the property. Section 203(e) equitably applies the same ratemaking standard to the "excess" in recorded income tax liabilities that regulatory commissions now apply to the "deficiency" represented by unrecorded income tax liabilities. Without the limitations in Section 203(e), some regulators could be tempted to reduce customer rates in one year or over a relatively small number of years, while continuing their existing practice of reflecting recovery of the unrecorded tax liabilities over the remaining lives of the property.

The Financial Accounting Standards Board (FASB) is reviewing the accounting for income taxes applicable to all corporations. While the theoretical basis of existing pronouncements (principally Accounting Principles Board Opinion No. 11-1967) apparently will be adjusted somewhat, the main impact of the revised FASB Statement, which is expected to be released by the end of 1987, is that the interest-free loan must continue to be recorded on the liability side of the the balance sheet by all corporations.

The existing exception that allowed public utilities to ignore unrecorded tax liabilities (the loan from the U.S. Treasury) when the regulator flowed through the principal of the loan, would be eliminated. The economic effect of flow-through ratemaking would then be reflected on the balance sheet of the affected public utilities by showing a receivable from future customers offset by the previously unrecorded deferred tax liability. We understand that the new pronouncement is to be effective in 1989, but adoption by taxpayers as early as 1987 would be permitted.

In summary, we support the continuation of Section 203(e) in the Internal Revenue Code because it will ensure ratemaking that is consistent with the often stated Congressional intent that the benefits of tax incentives related to property should be spread over the life of such property, and because it would lead to fairer ratemaking over the lives of the property giving rise to the tax incentives. Furthermore, the repeal of Section 203(e) could result in a significant immediate reduction in tax payments to the U.S. Treasury.

Mr. DORGAN. Thank you, Mr. Kujawa.
Mr. Sunley.

**STATEMENT OF EMIL M. SUNLEY, DIRECTOR OF TAX ANALYSIS,
WASHINGTON OFFICE, DELOITTE HASKINS & SELLS**

Mr. SUNLEY. Thank you, Mr. Chairman. The 1986 rule requiring normalization of the excess deferred tax reserves is the correct rule, and it should not be repealed. It is essentially a transition rule, relating to the tax treatment of property placed in service before 1986. A portion of the deferred tax reserves of utilities is no longer owed to the Government as a result of the reduction in corporate tax rates enacted in 1986.

The normalization of this excess deferred tax reserve ensures that amounts no longer owed to the Government are returned to utility customers at the same time they would have been returned to the Government if the tax rate had not been reduced.

The debate over whether the excess deferred tax reserve should be normalized or not is only a debate over when the excess deferred tax reserve should be returned to customers. Both proponents and opponents of H.R. 1049 agree that the deferred tax reserve should be returned to customers. The issue is only one of timing.

Congress provided in the Tax Reform Act of 1986 that the benefits of ACRS depreciation would be denied if a utility fails to normalize either the ACRS benefits arising from new investments, or the recovery of its excess tax reserve. As with other normalization requirements, normalizing the recovery of a utility tax reserve does not result in a windfall gain for the utility.

Whether the excess deferred taxes are normalized or flowed through immediately affects the pattern of the after-tax cashflow of the utility. However, because accumulated deferred income taxes are offset against the rate base, the utility earns a constant after-tax rate of return on invested equity under either flowthrough or normalization.

Normalization also does not involve a windfall burden on customers. Normalization treats customers equitably over time and avoid sharp fluctuations in utility rates.

The Joint Committee on Taxation stated in a letter from Mr. Brockway to Mr. Dorgan that H.R. 1049 would not have any significant revenue impact on the Federal Treasury. I would like to address that issue in the final part of my statement.

I believe that this revenue estimate is correct, at least as a first approximation. Although utilities may pay substantially lower taxes during the flowthrough period than they would if the excess deferred tax reserve were normalized, the flowthrough/normalization issue traditionally has not been viewed as having an aggregate revenue effect. And the reasoning is as follows. The income of the utilities go down as a result of flowing through the excess deferred tax reserves, but the income of other companies go up. The critical assumption is that money GNP is not affected.

This, however, is only a first approximation and there may be secondary effects, and Mr. Steuerle alluded to these in his testimony on behalf of the Treasury Department this morning.

There may be, one, differences in marginal tax rates across sectors of the economy. Two, differences in the timing of tax payments if there were a sudden shift away from normalization toward flowthrough accounting, and three, an interaction with excise tax revenues. Mr. Steuerle mentioned both the second and third of these effects when he was pressed to elaborate on what secondary effects there may be.

I strongly suspect that if the Joint Committee were asked to examine these secondary effects they would conclude that once secondary effects were taken into account that H.R. 1049 would have a negative revenue effect.

Now I am not suggesting that the question of whether or not Congress should enact 1049 should hinge on the revenue effect. I believe the normalization of the excess deferred tax reserve is the correct rule. It follows the long tradition of Congress and the administration of supporting normalization of tax benefits provided the utility industry. That the rule should be retained because it is the correct rule.

But if pressed, I believe both the Treasury and the Joint Committee would agree that if secondary effects were taken into account—something that they have always been reluctant to do—they would agree that the revenue impact of H.R. 1049 is probably a small minus.

Thank you very much.

[The statement of Mr. Sunley follows:]

STATEMENT OF
EMIL M. SUNLEY

ON THE NORMALIZATION OF EXCESS DEFERRED TAX RESERVES
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES

DECEMBER 14, 1987

I am Emil M. Sunley, Director of Tax Analysis in the Washington Office of Deloitte Haskins & Sells, an international accounting firm. I welcome this opportunity to present testimony on behalf of Deloitte Haskins & Sells on the normalization of excess deferred tax reserves. Both in the Government and since leaving the Government, I have been involved with the issue of normalization versus flow-through of utility tax benefits. I first worked on this issue at the Treasury Department during the consideration of the 1969 and 1971 Tax Acts. As Deputy Assistant Secretary for Tax Policy, I testified in 1979 for the Treasury Department before the Ways and Means Oversight Subcommittee on the appropriateness of the utility normalization rules. I have written extensively on utility normalization; most recently "Normalization of Utilities' Excess Tax Reserves," in the June 29, 1987 issue of "Tax Notes."

H.R. 1049, the "Utility Ratepayer Refund Act of 1987," introduced by Congressman Byron Dorgan, would repeal Subsection (e) of Section 203 of the Tax Reform Act of 1986. This provision of the 1986 Act extends normalization requirements to the "excess" deferred taxes attributable to the decrease in the corporate tax rate. At stake is an estimated \$15 billion in such "excess deferred tax reserves."

The 1986 rule is the correct rule, and it should not be repealed. It essentially is a transition rule: a portion of deferred tax reserves of utilities is no longer owed to the Government as a result of the reduction in corporate tax rates enacted in 1986. The normalization of this "excess" deferred tax reserve insures that amounts no longer owed to the Government are returned to utility customers at the same time they would have been returned to the Government if the tax rate had not been reduced.

Customers' Benefit from Tax Normalization

The debate over whether the excess deferred tax reserve should be normalized or not is a debate over when the excess deferred tax reserve should be returned to customers. Both proponents and opponents of H.R. 1049 agree that the deferred tax reserve should be returned to customers. The issue is only one of timing. In 1986, Congress provided that the excess deferred tax reserve should be normalized. The precedent for normalization is longstanding. Congress first enacted normalization requirements in 1969 and subsequently expanded those requirements in 1971, 1975, 1981, and 1982. Normalization of income tax expenses has been preferred by the Congress and most regulatory commissions as a matter of regulatory policy.

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The principal benefits of normalization are:

- Equity Among Customers. Just as it would be unfair to charge customers in the latter half of an investment's lifetime with a disproportionate share of the original capital cost of the investment, so too is it unfair to deny those customers a fair share of the benefit of tax depreciation generated by that investment. Normalization allows a proper matching over time of the income tax expense and the underlying items of income and expense giving rise to the income tax expense.
- Rate Stability. If accelerated tax depreciation and other investment-related tax savings were flowed through, utility rates to customers would fluctuate with the rate of new investment. Utility rate fluctuations make it more difficult for customers to plan effectively (e.g. to determine the cost savings from energy conservation) and they expose the utility to the risk that regulatory commissions will be slow in restoring utility rates to reflect a higher cost of service.
- Cost of Capital. Although not susceptible to precise quantification, normalization of income tax expense results in lower cost of debt and equity for the utility and, thus, lower rates for customers. Lower capital costs are obtained because: (1) the utility's cash flow is stabilized for the reasons set forth above and thus the utility's securities have lower risk, and (2) the utility's needs to raise capital in external capital markets is diminished.

Normalization of Excess Tax Reserve

Realizing that regulatory commissions would be petitioned to flow through the excess tax reserves to current customers, Congress provided in the Tax Reform Act of 1986 that the benefits of ACRS depreciation would be denied if a utility fails to normalize either the ACRS benefits arising from new investments or the recovery of its excess tax reserve.

As with other normalization requirements, normalizing the recovery of a utility tax reserve does not result in a windfall gain for the utility. Whether the excess deferred taxes are normalized or flowed through immediately affects the pattern of the after-tax cash flow of the utility. However, because accumulated deferred income taxes are offset against the rate base, the utility earns a constant after-tax rate of return on invested equity under either flow-through or normalization.

What is the Public Interest?

The direct public interest in this issue can be measured by (1) the cost of service incurred by the utility and charged to the public through the utility's rates, minus (2) income taxes paid by the utility. That is to say, if under one scenario the utility pays less income tax than it does under another scenario, the income tax shortfall represents a cost to the public that should be subtracted from the differential in the cost of service when measuring the net cost to the public. This is just another way of saying that the public, not the utility's investors, bears the economic burden of the utility's income tax under the cost-of-service approach to utility ratemaking.

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To evaluate the public interest over an extended period of time, the utility's cost of service and taxes paid must be adjusted to reflect the time value of money. For these purposes, I have discounted both amounts by the utility's weighted average cost of capital. This is the rate of return a utility customer could earn if he or she invested in the utility's debt and equity. The table below shows the present value of cost of service, income taxes paid, and net cost to the public for 1987-2011 under alternative methods of restoring the excess tax reserve: normalization, one-year flow-through, and three year flow-through. The full detail of these calculations are given in the June 29, 1987 article in "Tax Notes."

Net Present Value of Cost of Service, Income Taxes Paid, and
Net Cost to Public, 1987-2011, Under Alternative Methods
of Restoring the Excess Tax Reserve

Net Present Value of:	Normalization	One-Year Flow-through	Three-Year Flow-through
Cost of Service	\$89.97	\$89.48	\$89.53
Income Tax Paid	9.60	9.11	9.16
Net Cost to Public	80.37	80.37	80.37

While the net present value of the utility's cost of service and income taxes paid varies slightly, the variation is relatively small. More significantly, the net cost to the public is identical under each of the three methods because variations in the net present value of the utility's cost of service are attributable to, and offset by, the income taxes paid by the utility.

The preceding analysis is predicated on the assumption that the utility's cost of capital is not affected by the method used to restore the excess tax reserve to the cost of service. However, under a flow-through method, a utility would have to issue new debt and equity to refinance over a period of one to three years the entire excess tax reserve resulting from the reduction of the corporate income tax rate from 46 percent to 34 percent. If a utility had to issue large amounts of such debt and equity within the same one- to three-year interval, the impact on the utility's cost of capital and thus its cost of service could be significant.

If the discount rate is held constant, any increase in the utility's cost of capital under the flow-through method would result in a higher net cost to the public than the net cost would be under normalization. Moreover, if the cost of debt and equity are both increased by 15 basis points or more, the net present value of the utility's cost of service would be higher under the flow-through than under the normalization method. So while the impact of flow-through on the utility's cost of capital cannot be quantified with any precision, even a relatively small impact would result in utility customers bearing a cost of service with a higher net present value than that arising under the normalization method.

Revenue Effect of H.R. 1049

The Joint Committee on Taxation stated in a letter that H.R. 1049 "would not have any significant revenue impact on the Federal Treasury." (Letter from David H. Brockway to Mr. Byron Dorgan, April 3, 1987.) This revenue estimate is correct, at least, as a first approximation.

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Although utilities may pay substantially lower taxes during the flow-through period than they would if the excess deferred tax reserve were normalized, the flow-through-normalization issue traditionally has not been viewed as having an aggregate tax revenue effect. The reasoning is as follows: If a public utility were required to flow-through its excess tax reserve, it would reduce its charges to customers by a certain amount, say \$100. If the utility's income is taxable at a 34 percent, Federal taxes paid by the utility would be reduced by \$34. However, the utility's customers will spend the \$100 they save on their utility bills to purchase other goods and services, thereby raising the incomes earned by other sectors by the \$100 diverted from the utility. If the other sectors pay tax at the same marginal tax rate as the public utility sector does, \$34 in additional taxes will be paid by those other sectors. Under these assumptions, tax payments are simply shifted from one sector to another, with the total tax paid remaining fixed at \$34. Later, after the flow-through period has ended, utility bills will be higher, expenditures on other goods and services will be pared, and the origin of income tax payments will shift from other sectors back to the public utility.

This, however, is only a first approximation. There may be (1), differences in marginal tax rates across sectors of the economy, (2) differences in the timing of tax payments if there were a sudden shift away from normalization toward flow-through accounting, and (3) an interaction with excise tax revenues. If utilities' marginal tax rates are higher than those of other businesses, the taxes paid by utilities will be reduced by a greater amount than the increase in taxes paid by other businesses even though the underlying changes in income offset one another. If the marginal tax rates differ by 2 percentage points, each \$1 billion reduction in the utility revenues would result in a \$20 million reduction in Federal tax revenues. Thus, a \$15 billion reduction in utility revenues on account of flow-through would result in a \$300 million Federal revenue reduction.

I strongly suspect that the income earned by utilities bears a higher marginal tax rate than the average for other businesses for the following reasons:

- With repeal of the investment tax credit and significant reductions and accelerated depreciation, most utilities will be paying taxes at the maximum corporate rates. By contrast, other businesses may be incorporated, but paying tax at lower marginal rates, or be unincorporated and able to avoid the double taxation of income earned through corporations. Moreover, some businesses are tax-exempt (charities, educational and child care organizations, club and fraternal organizations, churches and other religious organizations).
- Utilities' compliance and reporting of taxable income and deductions is surely better than other businesses taken as a whole. In addition to filing tax returns and preparing audited financial statements for shareholders and creditors, utilities' books are regularly audited by state and Federal regulatory agencies. Virtually all transactions in which they engage are reflected in written records (e.g., bill sent to customers) and paid by check, not by cash.

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Flowing through the excess tax reserves could affect a temporary reduction in tax receipts on account of timing considerations. Utilities, like other corporations, are required to pay estimated tax during the course of the year based on their estimated income for the year. If ordered by regulatory commissions to flow-through the excess tax reserve, they could and presumably would make a relatively quick adjustment in their estimated tax payments. However, their business customers would probably be somewhat slower to recognize the increase in taxable income and thus somewhat slower to adjust their estimated tax payments. Thus, they increase in taxes paid by businesses benefitting from utility rate reductions would lag the reduction in taxes paid by the utilities.

The third factor that would affect the revenue impact of flow-through is the telephone excise tax. If the telephone companies are required to flow-through the excess deferred tax reserves, telephone excise tax payments go down in the short-run. This is not offset by increased excise taxes from other sectors of the economy. For example, if telephone companies are required to flow-through \$100 of excess deferred tax reserve, excise tax payments go down by \$3 and income tax payments go down by \$33 (34 percent of \$97) for a total reduction in taxes of \$36. If the telephone customers spend the \$100 they save on their utility bills to purchase other goods and services, the other sectors will pay \$34 more in tax assuming the other sectors are at the same marginal income tax rate as the public utility sector. When excise taxes are involved, taxes are not simply shifted from one sector to another with the total tax paid remaining fixed.

Summary

Normalization of a utility's excess tax reserve under the average rate assumption method results in neither a windfall gain for utilities nor a windfall burden for customers. By spreading the recovery of the excess tax reserve over the lives of the utility's investments which gave rise to the excess tax reserve, normalization treats customers equitably over time and avoids sharp fluctuations in utility rates. The net cost to the public when measured in present value terms is the same under normalization and flow-through if the utility's after-tax cost of capital is the same under both normalization and flow-through. Normalization, however, reduces a utility's need to raise new capital by issuing new debt and equity, thus reducing the utility's cost of capital. This reduction would result in lower net cost to the public.

Flowing through the excess deferred tax reserve temporarily shifts significant taxable income from public utilities to unregulated businesses and then gradually shifts taxable income back again. As a first approximation, the Federal tax revenue effect will be a wash. However, if (1) marginal tax rates differ between the regulated and the unregulated sectors of the economy, or (2) there are differences in the timing of estimated tax payments, or (3) excise tax payments are reduced, flow-through would reduce Federal tax receipts.

Mr. DORGAN. Thank you, Mr. Sunley.
Mr. Huntington.

STATEMENT OF SAMUEL HUNTINGTON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NEW ENGLAND ELECTRIC SYSTEM, ON BEHALF OF EDISON ELECTRIC INSTITUTE

Mr. HUNTINGTON. Thank you, Mr. Chairman. My name is Samuel Huntington. I am president and chief executive officer of New England Electric System. And I am here on behalf of the Edison Electric Institute, the association of investor-owned electric utilities. And thank you for giving me the opportunity to appear today and to discuss H.R. 1049.

The electric utility industry believes the transition rule for excess deferred taxes embodied in section 203(e) of the 1986 Tax Reform Act should be retained, and thus opposes H.R. 1049. We oppose it for essentially four reasons.

First, enactment of the bill would provide no net present value benefits to customers.

Second, enactment of the bill would upset the careful balance struck in the 1986 Tax Reform Act concerning electric utilities.

Third, enactment of the bill would be contrary to longstanding Federal tax policy favoring normalization.

And finally, the bill, as Mr. Kujawa pointed out, fails to recognize as an offset to excess deferred taxes, large tax liabilities owed by utilities for tax incentives previously flowed through to customers. These liabilities for which no deferred tax reserves exist are in large part greater for the industry as a whole than the excess deferred taxes addressed by H.R. 1049.

Let me comment briefly on the first three points. First, careful analysis shows that our customers are no better off on a present value basis by getting excess deferred taxes now rather than later. In fact, they may be worse off when the increased cost of capital to utilities for replacing these funds is taken into account.

Beyond that, an early return could drastically distort rates. If they were returned over say a 3-year period, rates would drop precipitously for 3 years. But they would then at the end of the 3-year period bounce back to a higher level, since the excess deferred taxes would no longer be available as a rate base deduction. Rates would then continue to be higher than they would be under the section 203(e) transition rule for many years.

Now sharply fluctuating rates that could result from H.R. 1049 would send totally inappropriate price signals to customers. In the Northeast, for example, we are facing potential electricity shortages this winter, and this tight supply situation could continue for many years. A sharp lowering of rates could spur consumption of electricity, precisely the wrong result given our current outlook.

My second major point is that the section 203(e) transition rule was a reasonable accommodation of utilities' capital formation needs given the drastic reductions in utility cash-flows from the other parts of the 1986 act.

Take my company as an example. The reduction of the corporate tax rate from 46 to 34 percent has reduced our customers rates through reductions already made by \$70 million per year. The loss

of the investment tax credit and other measures have reduced our cash flow on an annual basis by \$35 million. The reduction in cash-flow would have been much worse but for a series of transition rules, including the transition rule embodied in section 203(e).

The electric utility industry as a whole supported the Tax Reform Act despite the loss of some key capital formation incentives. We did so because of the significant benefits to our customers. Congress should not now destroy the careful balance struck in the 1986 act by repealing a very key transition rule.

Finally, longstanding Federal tax policy favors retention of the transition rule. Congress has endorsed on many occasions the concept of tax normalization. Normalization provides utilities temporary funds to invest in needed plant and equipment. These funds are then returned in orderly fashion over the lives of the assets so financed. To now allow an immediate return of tax benefits already invested in plant and equipment would penalize utilities and disrupt the federal policies behind normalization.

In conclusion, for these and the other reasons contained in my written testimony, H.R. 1049 should not be enacted. Thank you.

[The statement of Mr. Huntington follows:]

STATEMENT OF SAMUEL HUNTINGTON, PRESIDENT AND
CHIEF EXECUTIVE OFFICER, NEW ENGLAND ELECTRIC
SYSTEM, ON BEHALF OF THE EDISON ELECTRIC INSTITUTE

Mr. Chairman and Members of the Subcommittee:

I am Samuel Huntington, President and Chief Executive Officer of New England Electric System. New England Electric System is a public utility holding company whose subsidiaries serve the electricity needs of 1.2 million customers in the states of Massachusetts, New Hampshire and Rhode Island. I appreciate the opportunity to appear before you today representing the Edison Electric Institute (EEI) to present our views on H.R. 1049, the "Utility Ratepayer Refund Act of 1987."

EEI is the association of electric companies. Its members serve 97 percent of all customers served by the investor-owned segment of the industry. We generate approximately 76 percent of all electricity in the country and provide electric service to 73 percent of the nation's electric customers.

H.R. 1049 was introduced for the purpose of retroactively repealing Section 203(e) of the Tax Reform Act of 1986 (Act). Section 203(e) provides for the orderly flow-through to ratepayers of so-called excess deferred tax reserves of utilities, resulting from the reduction in the corporate tax rate, over the remaining life of the property to which such reserves relate. If enacted, H.R. 1049 would permit state regulators to order the immediate return of these excess deferred taxes for a one-time benefit to current customers, to the detriment of all customers in the future.

EEI strongly opposes H.R. 1049 for the following reasons:

- o H.R. 1049 would not provide the lowest cost for our customers.
- o H.R. 1049 would undermine the carefully designed balance of the Tax Reform Act of 1986, as it relates to electric utilities, before it has had a chance to work.
- o H.R. 1049 is contrary to long-standing federal tax policy.
- o H.R. 1049 fails to consider deferred income tax liabilities that have yet to be collected from customers.

The remainder of my testimony will discuss these reasons in depth and also will dispel some misunderstandings and misconceptions about H.R. 1049 put forth by its supporters.

H.R. 1049 Would Not Provide the Lowest Cost For our Customers

The primary responsibility of electric utilities is to provide adequate and reliable long-term service at the lowest cost to their customers. In fulfilling this service obligation, utilities are required to raise large amounts of capital for the construction of plant, as well as generation and distribution facilities, needed to satisfy customers' energy demands. The accelerated depreciation provisions of the Internal Revenue Code have played an important role in providing a portion of the capital needs of utilities for many years. Preservation of the capital formation incentive of accelerated depreciation, which section 203(e) permits, is not more expensive for our customers. It equitably ensures that this tax benefit is available to all utility customers who bear the cost of the related assets over their useful lives.

Section 203(e) prevents the consequences of erratic, short-term rate policies which can result in utility rate decreases in one year, paid for by rate increases shortly thereafter. It provides rate stability for customers who depend on limited, fixed incomes, such as many senior citizens and the poor.

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The fact that utility customers have always benefitted from deferred tax reserves, and will continue to benefit from the preservation of those reserves, is often misunderstood. Deferred tax reserves attributable to accelerated depreciation are universally treated by regulatory agencies as either rate base reductions or as zero cost capital. Either way, this contributes to lower customer rates. However, if Section 203(e) were repealed, utility rates would decline in the near-term but then would be followed by sharp increases caused by the loss of the rate base reduction and increased financing cost for replacement capital.

Emil M. Sunley, former Deputy Assistant Secretary (Tax Policy), U.S. Department of the Treasury, and Thomas Horst, both of Deloitte, Haskins and Sells, have extensively studied the impact of Section 203(e). In their study, they conclude:

In summary, normalization of a utility's excess tax reserve under the average rate assumption method results in neither a windfall gain for utilities nor a windfall burden for customers. By spreading the recovery of the excess tax reserve over the lives of utilities' investments which gave rise to the excess tax reserve, normalization treats customers equitably over time and avoids sharp fluctuations in utility rates. The net cost to the public when measured in present value terms is the same under normalization and flow through if the utilities after-tax cost of capital is the same under both normalization and flow through. Normalization, however, reduces utilities' need to raise new capital by issuing new debt and equity, thus reducing utilities' cost of capital. This reduction would result in lower net costs to the public.

Contrary to claims made that H.R. 1049 is a pro-consumer proposal, it is not. It fails to consider the economic interests of all the customers of an electric utility. If enacted, it will provide a windfall to a few customers in the near-term, while leaving customers in future years without their share of the tax benefits. Not only will H.R. 1049 deny future customers an equal share of the tax benefits related to plant investment, it will also leave them exposed to future utility rate increases resulting from possible future corporate income tax rate increases. When all the ramifications of H.R. 1049 are considered, it is clear that it is a special interest, anti-consumer proposal. Some large industrial customers seem to be more concerned with a short-term infusion of cash than with long-term rate stability and equity for all customers. The unfortunate results of such action will be higher electric rates for our customers and your constituents.

H.R. 1049 Undermines the Balance of the Tax Reform Act

The Tax Reform Act of 1986 involved the most comprehensive restructuring of our federal tax system since 1954. The electric utility industry strongly supported the provisions of that Act principally because of the overall favorable effects it would have on our customers. Since its enactment in October 1986, many of our customers have already begun to realize these benefits through lower tax expense reflected in electric rates.

Most of the changes provided in the Act did not become effective until this year. Thus, taxpayers are now only beginning to realize the important tax impacts and broader economic implications that will result. To prematurely change an integral provision of the Act, as contemplated by H.R. 1049, would defeat the intended purpose of last year's tax reform legislation before it has had time to work.

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During the legislative process, we repeatedly expressed serious concern over the long-term effect that tax reform would have on capital formation for our industry. As the most capital intensive industry in the nation, we are keenly aware of the important role that capital formation incentives have played in keeping the cost of electricity affordable for individuals and businesses.

Capital formation continues to be a most important matter for our industry. Forecasts of electricity demand by the U.S. Department of Energy, published in the Annual Energy Outlook, indicate that annual growth rates will average 2.6 percent through the year 2000. Additional electric generating capacity will be required by the mid-1990's to meet this new demand. In some regions, despite comprehensive conservation, load management practices and plant-life extension programs, new capacity will be needed even earlier. Contrary to the fallacy that utilities construct facilities for tax reasons, capital expenditure decisions are neither tax nor profit motivated; rather, they are dictated by energy demands that must be met in accordance with the utilities' franchise.

The 1986 Act, by repealing the investment tax credit, lengthening depreciation lives and capitalizing construction period interest and overheads, severely reduced capital formation incentives previously available. Our estimates indicate that, because of the Act, the need to raise debt or equity capital by member companies will increase significantly. In fact, average internal cash flow used to meet construction expenditures have already begun to decrease and are estimated to decrease by about 25 percent annually in the 1990's. If Section 203(e) of the Act is repealed, a most serious additional capital formation obstacle will be placed on our industry.

Congress recognized that the capital formation provisions already in the Internal Revenue Code must not be precipitously withdrawn; otherwise, serious harm to segments of the economy could result. Numerous important transition rules were enacted for this purpose. In the case of regulated utilities, Section 203(e) addresses this transitional concern by providing for the gradual reduction of depreciation-related excess deferred tax reserves created by the reduction in the corporate income tax rate.

Congress determined that the reduction in the deferred tax reserves should take place over the lives of the assets involved by use of the "average rate assumption method." Such a method reduces the tax reserves in much the same manner as those tax liability reserves would have been reduced had the corporate income tax rate remained unchanged. This gradual reduction (1) prevents an abrupt and premature erosion of a utility's capital; (2) provides each customer who pays for a plant or facility with a share of the tax benefits over the useful life of that asset; and, (3) prevents a windfall to present customers which will have to be recouped if the corporate tax rate were to rise.

The average rate assumption method preserves the originally intended timing of these payments and thus assures that tax reform does not adversely effect prior capital investment decisions. This is particularly critical to the electric utility industry because, as a practical matter, amounts represented by deferred tax reserves are generally not in the form of cash that can be provided to customers at will. The deferred tax reserves become a principal source of capital utilized in the financing the plant and equipment.

H.R. 1049 could cause the premature payment of these deferred tax reserves, which will be funded by many utilities through the issuance of new debt or equity. Thus, if enacted, H.R. 1049 will retroactively penalize prior investments in plant and facilities and will ultimately result in higher electricity rates for our customers, your constituents.

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Not only would enactment of H.R. 1049 undermine the carefully crafted balance of the Tax Reform Act, but it would also specifically single out and discriminate against the utility industry. Most unregulated businesses have excess tax reserves which will not be paid to the U.S. Treasury or passed on to customers as a result of the Tax Reform Act. However, H.R. 1049 does not apply to all business enterprises, but rather focuses strictly on regulated utilities. This is clearly unfair and inequitable.

H.R. 1049 is Contrary to Federal Tax Policy

The benefits resulting from accelerated depreciation and the investment tax credit clearly were provided by Congress to promote and assist plant modernization and expansion throughout the American economy or, in other words, for purposes of capital formation. As a capital formation incentive, a primary intent of Congress was to encourage economic development by reducing the net cost of new equipment. Normalization provisions were added to the Code to assure that these capital formation incentives would be available to regulated public utilities and would not be nullified during the process of setting utility rates. The normalization provisions are essential (1) to insure that federal tax policy is applied uniformly throughout the nation; and (2) to provide equality among all customers, present and future, in the sharing of such tax benefits.

Prior to enactment of the normalization provisions, considerable controversy existed concerning the regulatory treatment to be afforded to capital formation incentives. Many regulatory commissions ordered utilities within their jurisdictions to flow-through the capital formation tax incentives immediately to current customers, while in other jurisdictions varying forms of normalization were permitted. The flow-through practice was politically attractive to regulators, because it resulted in lower near-term utility rates. However, this practice can result in serious negative long-term implications, such as artificial under-pricing of utility services, ultimately leading to higher product demand and increased costs of capital leading to higher customer rates. Flow-through also causes inequitable treatment among generations of customers through its disproportionate allocation of greater tax benefits to customers in the early life of a plant rather than to customers who are served by the same plant in its later stages.

The legislative precedent for normalization is both long-standing and well-accepted. In 1969, Congress first codified normalization rules, which then only dealt with accelerated depreciation benefits, in order to halt the trend toward the flow-through method and to prevent significant Treasury revenue losses that could otherwise be expected.²

Since 1969, the concept of normalization has been legislatively reaffirmed four times -- in 1971, 1975, 1981 and most recently in the Tax Reform Act of 1986. Interestingly, the President's Tax Reform Proposal of May 1985, which served as a stimulus for the 1986 Act, states that normalization was to be continued "in recognition of the historic practice of requiring normalization of investment incentives for regulated public utilities." Contrary to the suggestion that the normalization provisions in the 1986 Act were "slipped in" just before final passage, these provisions were included in the earlier separate House and Senate versions of the Act. The legislative history for the 1986 Act makes it abundantly clear that Congress intended to retain normalization and that Section 203(e) is an integral part of these normalization requirements.

Normalization was also the subject of separate Congressional hearings before the Ways and Means Oversight Subcommittee on March 1979, and the House Energy and Commerce Subcommittee on Energy, Conservation and Power in May 1984, when the U.S. Treasury Department reaffirmed its longstanding support for normalization. In its May 1984 testimony, the Treasury Department concluded:

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...we believe that (1) normalization is the appropriate accounting technique, (2) the Congressional intent is well served by normalization, and (3) enforcement through the Code has generally been effective,...

Not only is there strong legislative support for normalization, but also this practice is equally well supported by ratemaking rules and accounting principles. In 1981, the Federal Energy Regulatory Commission (FERC), the federal agency responsible for ratemaking in wholesale electric transactions, after an extensive investigation, unanimously adopted a rule (FERC Order No. 144) requiring tax normalization. In adopting Order No. 144, FERC stated:

...tax normalization better achieves the goals of equity and fairness than does flow-through....tax normalization matches tax benefits with cost responsibility....Flow-through, through its inequitable allocation of tax costs over time, is found to distort the Commission's pricing policies.

It is interesting to observe that FERC, in a 1987 rulemaking proceeding, noted the need for its jurisdictional utilities to adhere to the Code requirements to use the average rate assumption method in returning excess deferred taxes. Concerning these requirements, FERC stated:

"Jurisdictional companies would not receive a windfall from this approach, since the excess accruals are used as a rate base deduction until the excess is returned to customers."

Normalization has been a generally accepted accounting principle employed by U.S. business enterprises since 1954. The requirement to employ normalization accounting in the preparation of financial statements is embodied in Accounting Principles Board Opinion No. 11, which concludes:

...the deferral method of tax allocation [normalization] should be followed since it provides the most useful and practical approach to interperiod tax allocation and the presentation of income taxes in financial statements.

Thus, the legislative, regulatory and accounting precedent for normalization is well-established. Furthermore, the intent of Congress to continue normalization, including an orderly flow back of excess deferred taxes resulting from the corporate tax rate reduction, could not be more clear. H.R. 1049 is contrary to long-standing federal tax policy and should not be adopted.

H.R. 1049 Fails to Consider Deferred Income Taxes That Have Yet to Be Collected from Customers

While it is true that utility companies may have excess deferred taxes, it is also true that many companies will owe taxes to the government yet to be collected from customers. This occurs because regulatory authorities historically have required the immediate pass-through of certain tax benefits such as accelerated depreciation. Such action was accompanied by adopting the flow-through method of accounting instead of normalization. The result of the flow-through practice is that utilities have billions of dollars in existing tax liabilities that will be owed to the Treasury in the future for which no collection of taxes from customers has occurred. In order to determine the actual tax liability owed to Treasury, and that is required to be recognized on utility financial records, it is necessary to consider not only the excess deferred taxes, but also the existing liabilities arising from prior flow-through practices that are owed by customers. On an industry basis, the amount of unfunded tax liabilities yet to be collected from customers is probably greater than the excess deferred taxes resulting from the corporate income tax rate change.

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Consequently, the enactment of H.R. 1049 would clearly benefit today's customers at the expense of future customers. It makes no sense to refund the excess deferred taxes and then have to collect the unfunded liability from future customers.

Misunderstandings and Misconceptions about H.R. 1049

There appear to be certain misunderstandings and misconceptions with respect to the bill's application. The following discussion is provided to clarify these misunderstandings.

Federal Tax Policy Versus Case-by-Case Approach

Supporters of H.R. 1049 claim that the bill would return to the state utility regulators the discretion to decide appropriate refund schedules on a case-by-case basis. Such an approach is ill-conceived because it would inappropriately transfer the responsibility for federal tax policy to state authorities.

When Congress adopted normalization of accelerated depreciation, it did so to ensure that the tax benefits of accelerated depreciation would be treated equally by all rate setting authorities, would not be flowed through, and would be used to foster capital formation. To permit these tax benefits, which are provided by the federal government and not by rate-setting authorities, to be separately administered on a case-by-case basis, clearly would negate Congressional intent. Congress makes federal income tax policy. Similar to the fact that federal income tax rates are not decided at the state level, it should not be left up to the discretion of individual rate-setting authorities' as to how federal tax policy should be administered. We believe that Congress correctly and specifically provided for a uniform, national treatment for all utility customers and companies by including Section 203(e) in the Act. Individual state public utility commissions should not be allowed to establish federal tax policy.

Utility "Diversification"

One misconception that exists is that some utilities are using excess deferred taxes for diversification activities. This simply is not so. While some utilities have diversified, it is not true that they have done so with funds that will be provided to ratepayers. Shareholders equity, not excess deferred tax reserves, is used for diversification activities. On the other hand, deferred income taxes are accounted for entirely separate from shareholder equity and are used as rate base reductions as intended by Congress. The utility industry is closely regulated, and such regulation properly ensures that utilities engage in diversification using only funds contributed by investors.

Cost of Capital

Some industrial consumers contend that the utility cost of capital is lower than their cost of capital. Their conclusion is based on the assumption that funds borrowed by utilities to fund the excess deferred tax payments would be obtained at a lower rate than the cost of capital in other industries. This is not so. Based on historical statistics maintained by Moody's Investors Service, the cost of utility capital in fact, on average, has been consistently higher than those of industrial concerns. Further, increased borrowings would drive up the utilities cost of capital even more.

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Cash in the Bank

Another misunderstanding is that accumulated deferred tax reserves represent cash in the bank. Again, this is not so. Deferred tax reserves are nothing more than accounting balances on the books that represent a future liability of a company. The monies represented by these reserves are used for capital investments in plant and equipment as intended by Congress and generally approved in advance by public utility commissions. A short-term or premature flow-back of these reserves will force most utilities to borrow and, thereby, increase capital costs, in turn creating rate increases for our customers.

Conclusion

We urge that the Subcommittee reject H.R. 1049, because it is contrary to sound and long-standing federal tax policy and, in the long run, would be detrimental to our customers.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions you or members of the Subcommittee may have.

FOOTNOTES

1. "The trend of recent years has been that regulated utilities previously on straight line depreciation have been shifting to various forms of accelerated depreciation. At the same time, regulatory agencies which had previously permitted the tax deferrals resulting from accelerated depreciation to be 'normalized' (computing the greater Federal income tax liability that would have resulted from use of straight line depreciation and adding this amount to a reserve account for future tax liability on the regulated utility's books of account) have been shifting toward requiring the flowing through to customers currently of the tax deferrals resulting from the use of accelerated depreciation. Finally, within the past 12 months several agencies have imputed accelerated depreciation in determining the Federal tax expense of the utilities, and flowed through the resultant tax deferrals, even through the particular utilities involved were in fact using straight line depreciation and in fact were paying the greater current Federal income taxes resulting from the use of that method of depreciation." (From Report of Ways and Means Committee on the Tax Reform Act of 1969, 1969-3 C.B. 282-283.)
2. "In general, flowing through the tax deferral to the customers of a utility that is already earning its maximum permissible profit on its investment, results in a doubling of the Government's loss of revenue from the use of accelerated methods of depreciation for tax purposes. This is because the current tax reduction reduces the rates charged to customers, which in turn reduced the utility's taxable income and therefore reduced its income tax. This second level of tax reduction is passed on to the utility's customers, with the same effect. Assuming no other factors become involved, the total loss of taxes may be computed as the initial loss dividend by the excess of 100 over the utility's marginal tax rate. At the present surcharge rates, the total tax loss is 212 percent of the initial loss; without the surcharge, the total loss is 192 percent of the initial loss.

Your committee has been advised that, if those trends were to continue, there could very shortly be a revenue loss of approximately \$1.5 billion: some estimates indicate that the loss might be considerably closer to \$2 billion per year. Your committee has determined that the likely revenue loss from wholesale shifts to accelerated depreciation and flow-through is unacceptable at this time.

Consideration has been given to suggestions by the Federal Power Commission and others that regulated utilities no longer be permitted to use a method of depreciation other than straight line. However, your committee concluded that, in too many cases this would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Also, this would result in prompt, substantial, and widespread utility rate increases.

Accordingly, your committee has determined in general to 'freeze' the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more healthy utility industries. No change is made regarding utility industries whose members are, by and large, earning well below their permitted rates of return." (From Report of Ways and Means Committee on the Tax Reform Act of 1969, 1969-3 C.B. 282-283.)

More recently, a report of Emil Sunley and Thomas Horst, "Impact on Federal Tax Revenues of Normalization of Regulated Utilities Excess Tax Reserves," reached the following conclusion:

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"... flowing through the excess tax reserves would result in a loss of federal tax revenues during the flow-through period on account of the higher effective tax rates applicable to income earned by utilities versus other businesses and on account of the time lag between the reduction in taxes paid by utilities and the increases in taxes paid by other businesses."

3. The following data appears in Moody's Utility Manual:

Moody's Weighted Averages of Yields
on Newly Issued Domestic Bonds

<u>Year</u>	<u>Light, Power Gas</u>	<u>All Domestic Corporate Bonds</u>	<u>Difference Utility Greater Than Corporate</u>
1985	11.83	11.71	+ 0.12
1984	14.25	13.05	+ 0.80
1983	12.70	12.50	+ 0.50
1982	14.93	14.23	+ 0.70
1981	16.31	15.26	+ 1.05

Mr. DORGAN. Thank you, Mr. Huntington.

Mr. Bell, last evening I was looking through the testimony that had been submitted prior to the hearing, and on page 8 in your summary exhibit, I puzzled over that a bit because it showed a result that seemed to me to be beyond the pale of reasonableness. And I was trying to understand this morning when I came to the office what this summary meant.

It occurs to me you have presented a summary that excludes the time value of money as a consideration. Am I correct about that?

Mr. BELL. Yes, sir.

Mr. DORGAN. Then, is your exhibit of any value to us?

Mr. BELL. There are a number of factors involved. What this exhibit shows is the cost of refinancing the amount paid back on relatively different timeframes. And the offset is what the cost of financing would be at an 11-percent overall return, which is probably an understated return.

Mr. DORGAN. But to present a set of numbers that excludes the time value of money ignores the basic premise here that I think has been stated by Mr. Sunley, Mr. Huntington and others. If you do not consider the time value of money, I am not sure that you have presented me with anything of value. In fact, I think it distorts what the picture really is.

Mr. BELL. There are a number of corrections or modifications that could be made to get different results. I think probably the 11-percent return that was used understates the return on the refinancing of the money paid back. But certainly, you are right, there is not a time value of money reflected.

Mr. DORGAN. Could you provide for the subcommittee the same analysis using 10- or 12-percent discount rates?

Mr. BELL. And put a time value? Certainly.

[The following was subsequently received:]

Average Refund Per Residential Gas Customer
Utility Plant With 15 Year Remaining Life
Present Values @ 7%

	Simulated Dorgan One Year Refund	Simulated Dorgan Five Year Refund	Simulated Normali- zation Methodology (A)
Year 1	\$28.59	\$5.73	\$1.90
Year 2	(3.07)	4.72	1.57
Year 3	(2.67)	3.88	1.29
Year 4	(2.31)	3.18	1.06
Year 5	(1.98)	2.59	0.86
Year 6	(1.68)	(1.96)	0.71
Year 7	(1.41)	(1.65)	0.58
Year 8	(1.17)	(1.38)	0.48
Year 9	(0.96)	(1.12)	0.41
Year 10	(0.77)	(0.90)	0.37
Year 11	(0.60)	(0.70)	0.35
Year 12	(0.45)	(0.52)	0.35
Year 13	(0.32)	(0.37)	0.38
Year 14	(0.20)	(0.23)	0.43
Year 15	(0.09)	(0.10)	0.64
Totals	\$10.91	\$11.17	\$11.38

(A) Utilizing Reverse So. Georgia Method

Average Refund Per Residential Gas Customer
Utility Plant With 15 Year Remaining Life
Present Values @ 10%

	Simulated Dorgan One Year Refund	Simulated Dorgan Five Year Refund	Simulated Normali- zation Methodology (A)
Year 1	\$28.59	\$5.73	\$1.90
Year 2	(2.99)	4.59	1.53
Year 3	(2.53)	3.67	1.22
Year 4	(2.13)	2.92	0.98
Year 5	(1.77)	2.32	0.77
Year 6	(1.46)	(1.71)	0.61
Year 7	(1.20)	(1.40)	0.49
Year 8	(0.96)	(1.13)	0.40
Year 9	(0.77)	(0.90)	0.33
Year 10	(0.60)	(0.70)	0.29
Year 11	(0.45)	(0.53)	0.27
Year 12	(0.33)	(0.39)	0.26
Year 13	(0.23)	(0.26)	0.27
Year 14	(0.14)	(0.16)	0.30
Year 15	(0.06)	(0.07)	0.43
Totals	\$12.97	\$11.98	\$10.05

(A) Utilizing Reverse So. Georgia Method

Average Refund Per Residential Gas Customer
Utility Plant With 15 Year Remaining Life
Present Values @ 12%

	Simulated Dorgan One Year Refund	Simulated Dorgan Five Year Refund	Simulated Normali- zation Methodology (A)
Year 1	\$28.59	\$5.73	\$1.90
Year 2	(2.94)	4.51	1.50
Year 3	(2.44)	3.54	1.18
Year 4	(2.01)	2.77	0.93
Year 5	(1.65)	2.15	0.72
Year 6	(1.33)	(1.56)	0.56
Year 7	(1.07)	(1.26)	0.44
Year 8	(0.85)	(1.00)	0.35
Year 9	(0.67)	(0.78)	0.29
Year 10	(0.51)	(0.60)	0.25
Year 11	(0.38)	(0.44)	0.22
Year 12	(0.27)	(0.32)	0.21
Year 13	(0.18)	(0.21)	0.22
Year 14	(0.11)	(0.13)	0.24
Year 15	(0.05)	(0.06)	0.34
Totals	\$14.13	\$12.34	\$9.35

(A) Utilizing Reverse So. Georgia Method

Mr. DORGAN. One of the points you made, Mr. Bell, was that my bill would overturn longstanding Federal tax policy. I believe Mr. Huntington made the same point. I do not know what that longstanding Federal tax policy is with respect to excess deferred taxes. I understand what it is with respect to normalization and have no intention of attacking normalization in the coming months.

But with respect to excess deferred taxes, I want to try and understand what you mean by longstanding Federal tax policy. Mr. Bell.

Mr. BELL. We are referring—we cannot distinguish this between the overall tax policy of normalization. And that is the policy that has been stated in tax bills since 1969. And the tax partners of Arthur Andersen and the other accountants are probably able to cite more specifics. But we have reflected the normalization of tax benefits received from the Federal Government on a normalized basis since 1969. It has been a clear statement in most of the tax bills.

Mr. DORGAN. Your testimony refers to H.R. 1049 as forcing an immediate refund of excess deferred taxes. Is that not an overstatement?

Mr. BELL. I stand corrected by what that permits, certainly. It permits the State commissions to decide on 50 different bases, and the Federal basis as well, whatever they may elect.

Mr. DORGAN. Mr. Huntington, do you want to respond to longstanding Federal policy with respect to excess deferred taxes?

Mr. HUNTINGTON. Yes, I certainly would like to. As Mr. Bell stated, I do not see a distinction here between tax normalization and the treatment of these excess deferred taxes. In this case, these excess deferred taxes were collected pursuant to a Federal tax policy that provided that the tax benefits associated with accelerated depreciation should provide a pool of dollars available for investment in plant and equipment.

Now these tax benefits were collected in the past. By and large, they have been invested in plant and equipment. And that same tax policy says that those amounts should then be flowed back to consumers in an orderly fashion over the useful lives of the equipment in question.

So once those moneys have been collected and invested as contemplated by Congress in providing these tax benefits, then I think it is entirely reasonable that they be flowed back in accordance with the transition rule in section 203(e).

Mr. DORGAN. What if they have been collected and not invested? What if a utility company is cash flushed? Do you think it is reasonable for a regulatory body in that State to analyze whether or not maybe something could be done a little more rapidly in that area? Or do you think that is unreasonable?

Mr. HUNTINGTON. I think that is unreasonable. I think this is a national tax policy that traditionally has been applied across the board without case by case analysis and should continue. I think if you look at the electric utility industry as a whole, the vast majority of these funds have been invested in plant and equipment, and their return should be governed by Federal tax policy.

Mr. DORGAN. What happened to New England Electric as a result of the corporate tax rate decrease in 1978? Were you required to flow through immediately the excess deferred taxes?

Mr. HUNTINGTON. I can submit that for the record. I frankly do not recall.

[The following was subsequently received:]

At the time of the reduction in the corporate tax rate from 48 to 46 percent, we were not required to flowthrough the excess deferred tax. However, in 1987 during the ratemaking implementation of the 1986 Tax Reform Act, two of our rate jurisdictions, New Hampshire and Rhode Island, required us to flowthrough the 48 percent vs. 46 percent differential.

Mr. DORGAN. Would you remember if you had been required to flow it back? It seems to me that flow back is a fairly significant problem for utilities. If you had been required to flow it back, would you not recall that?

Mr. HUNTINGTON. I really do not know. At that time I had just joined the company. I just got an answer from our tax manager saying, no, they were not flowed back.

Mr. DORGAN. So they were normalized?

Mr. HUNTINGTON. They were normalized.

Mr. DORGAN. So under circumstances that my bill would permit, which is simply allowing the State regulatory bodies to make the decision, in 1978 your company received treatment that would have been similar to treatment that you would force on the regulatory bodies by section 203(e).

I guess the point I am making is that what happened to you as a result of the 1978 act was not the kind of treatment that you have asserted will occur if H.R. 1049 passed. You have suggested that if H.R. 1049 passes, next year you have got to dump that \$19 billion back to customers. Of course, that would not be the case. In some instances, my guess is State regulatory bodies would adopt normalization for their utilities, which is what happened to your utility in 1979.

Mr. HUNTINGTON. I think the order of magnitude of difference between a 2-percent and a 12-percent reduction in the tax rate is very significant. And I do not think you can look to what happened in 1978 as a clear indication as to what would happen if your bill were enacted.

I would simply rely on the statement I made before, that I think this is appropriately a matter of Federal tax policy and not individual State regulatory action.

Mr. DORGAN. Mr. Kujawa, you work for a fine company. I have worked with that company on projects over the years. Yet you indicated when you arrived that you were testifying on your own behalf. I know that your company does represent utilities. I do not know whether you just read in the paper this hearing was going on and decided to come up and give us your analysis of it. Were you asked by some of your clients to provide us your analysis?

Mr. KUJAWA. We were not requested. We requested on our own behalf that we appear before this panel.

Mr. DORGAN. Your testimony includes a statement that this bill could cost the Federal Treasury \$10 billion in revenue. Does that figure come from any empirical study that you have completed?

The reason I ask the question is Mr. Sunley and Treasury and Joint Tax all would concede that this bill has little or no Federal revenue impact. That is a very substantial difference with testimony that suggests a \$10 billion Federal loss. Can you tell me how you arrived at that number?

Mr. KUJAWA. Yes, sir. We looked at the amount of deferred taxes on the financial statements of the electric industry and computed the difference between the historical 46 percent tax rate on which they are provided, and the 34 percent rate of the 1986 Tax Reform Act. The difference is of the so-called excess tax reserve for that industry.

Now I am proceeding with this, Mr. Chairman, from the viewpoint of an accountant. And that is, depending on the extent to which State commissions require that to be—that excess to be flowed back rapidly, I know that the electric industry is going to pay the Treasury substantially less income taxes.

Now it is the burden of somebody else to say how magically that will be collected someplace else in the economy. But I know that utilities are going to be paying substantially less income tax.

Mr. DORGAN. But Mr. Kujawa, you would not, I am sure, counsel customers or clients who come to you, to be braced for the kind of impact that you are suggesting to this committee. You would certainly rely on history, and you would rely on past practice, and you would probably understand as I do, that only two States—two, out of all of the States, required the flow back on a 1-year basis in 1979. Another required the flowback on a year and-a-half basis. But in fact, a good many States allowed normalization.

I would guess you would not counsel a client, brace yourself, we are talking billions of dollars tomorrow. That would not be a professional approach. Moreover, you would not counsel us on the committee that we would expect the dire consequences tomorrow of losing \$10 billion in revenues, would you? That does not make sense to me.

Mr. KUJAWA. I think I couched it correctly, that it depends on the extent to which the States require the accelerated flowback of the so-called excess. And obviously those that are supporting your bill, Mr. Chairman, obviously are not here from an academic standpoint. They expect to make some changes. And the extent to which they make changes, the Treasury is going to collect less income taxes from those companies.

Mr. DORGAN. Is your \$10 billion predicated on the assumption that all \$19 billion would be flowed back in 1 year?

Mr. KUJAWA. That is the total amount, Mr. Chairman. That is the worst case. It depends on how fast it is. The faster it is, the bigger the impact from the standpoint of negative cashflows from the utility industry to the Treasury.

Mr. DORGAN. The only point I wanted to make is, I think the \$10 billion revenue loss is an alarming overstatement here. You know and I know that if H.R. 1049 passed today, the regulatory bodies would not uniformly move to a flowback in 1 year. In fact, many of them would probably not require flowback at all. In fact, if past practice is any evidence, there might be some States that would not require it be normalized.

So I just want to point out, a \$10 billion revenue loss is not the product of empirical evidence and won't be experienced in reality.

Mr. Sunley, the information you have provided is interesting information, and I read through the submission and your Tax Notes article sometime earlier. Was your firm working for someone when you did that study?

Mr. SUNLEY. That study was done for the Edison Electric Institute.

Mr. DORGAN. I just think that is important for the record. I do not suggest that your study does not have merit, and that you tried to conceal that. But I read through it one evening some while ago and I found it to be an interesting study. But I think always—

Mr. SUNLEY. It is stated in the study that it was done for the Edison Electric Institute.

Mr. DORGAN. Let me ask, Mr. Sunley, if you could respond to a letter I sent to you on September 21. We exchanged some views on some results that you reported in table 2. You were, in table 2, assuming a 10-percent discount rate and then talking about what would be the best case for the utility customers. I guess the lower net cost to the public is the term you used in your article.

I had asked you in a letter if you used 8 and 12 percent as opposed to the discount you raised of 10 percent, would that change your conclusions. We could debate a lot about what the discount rate ought to be. I could make an awfully good case for 12 percent. You might make a case for a lower percentage. But could you state for the record what your conclusion was using a 12 percent discount rate?

Mr. SUNLEY. May I preface my comment, Mr. Dorgan?

Mr. DORGAN. Yes.

Mr. SUNLEY. I refer to the results of that study in my written testimony. I did not refer to them in my oral statement. The 10-percent discount rate was the cost of capital of the utility. It was the weighted average cost of the debt and equity. It is at that discount rate that the utility has the same present value of the cash-flow, whether you normalize the tax benefit or flow it through. And everyone agrees on that.

The next issue is, are the customers better off or worse off if you normalize or flow through? And if the customers' discount rate is 10 percent, then the present value of their rates over the life of the property is the same. Net cost to the public is the same. That is what we demonstrated in the study which was published in Tax Notes.

The 10-percent discount rate can be viewed as what the customers can earn if they invest in the debt and equity of the public utility. In effect, they are supplying capital to the utility in the form of deferred tax reserves in the normalization case.

Now then the question comes, suppose the discount rate is 8 or 12 percent. At 8 percent, the net cost to the public of flowing it through is higher than if you normalize. At 12 percent it turns around. In other words, if the customer's discount rate is the same as the utility's discount rate, the customers are, as a group, indifferent between normalizing and flowing it through.

Now the difference between the 8- or 12-percent discount rate is very small.

Mr. DORGAN. But you understand why I am raising the question. Assumptions are everything. If assumptions meant anything, we would have a balanced budget and 1 percent interest rate and zero unemployment. If you go back to look at the assumptions in the 1981, 1982, 1983 budget submissions by the White House, this country would have no problems at all.

Assumptions predict the results you are going to get from your model. That is why I raise the question of the assumption of Mr. Bell on time value of money, and I raise the question of the assumptions used with respect to the discount rate.

Mr. McGrath.

Mr. McGRATH. Thank you, Mr. Chairman.

Mr. Sunley, is it not true that underlying the conclusion of your company's report that more rapid refunds lower the utility cost of service to ratepayers over both the short and long term is an assumption that the cost of capital will remain constant in spite of the rapid refund of the funds and the resulting demand for replacement capital?

Mr. SUNLEY. I am sorry, Mr. McGrath, I do not believe that was the conclusion of my study.

Mr. McGRATH. That the cost of capital would remain constant.

Mr. SUNLEY. That is the assumption. But the first part of your statement—

Mr. McGRATH. How likely is that, that the cost of capital would remain constant?

Mr. SUNLEY. I would suggest that if the utilities had to go out to the market and replace the excess deferred taxes by debt and equity, that their cost of capital would go up.

Mr. McGRATH. Now what would be the effect of that if every utility in the country had to do that at the same time?

Mr. SUNLEY. I am not one that can predict what the impact on the overall cost of capital would be. What we did do in our study was to say that if it was, I believe, as small as 15 basis points even at a 12-percent discount rate for the customers, it would tilt the scale the other way. It does not require very much of an impact on the cost of capital of the utilities, for the customers to be better off with normalization, even if their discount rate is significantly above the cost of capital of the utilities.

Mr. McGRATH. And the compounding effect in at least one State, like mine, if all of these rapid refunds were to happen at a similar rate for all of the utilities in the State. Even if only for two of them, the two largest as the commissioner had testified this morning, that represents about two-thirds of that particular fund. What would the effect be on the rates of those two particular utilities at that time? Would not the PSC have to factor in the cost of capital into the ratemaking procedure at that time?

Mr. SUNLEY. Most certainly, because the utility commission must provide—

Mr. McGRATH. It is not done now, am I correct?

Mr. SUNLEY. Yes, the utility commission must provide rates which will allow the utility, both to borrow on the capital markets and to raise new equity as needed. Commissions must provide a fair return, or the utility will not be able to go back to the capital markets.

Mr. McGRATH. Mr. Huntington, in the case of the New England Electric System, if we forced your utility to return excess deferred funds immediately or on an accelerated basis, would this not increase the rates of your ratepayers?

Mr. HUNTINGTON. Yes, I believe it would. We would be forced—our total excess deferred taxes is \$100 million for the utility part of our business. And if we were forced to return that over a relatively short period of time, we would indeed have to go raise additional funds.

I should point out that the cost of capital to utilities in the industry has already gone up as a result of the reduction in cashflows from the other provisions of the Tax Reform Act of 1986. And the loss of this cashflow by the repeal of the section 203(e) transition rule would just exacerbate that problem.

Mr. McGRATH. I asked the question of Treasury this morning. I will probably ask it again, and maybe you can take a rip at it. I guess the effect of a reduction in the corporate rate from 46 to 34 percent produced somewhere in the neighborhood of a \$15 to \$19 billion windfall for the utilities. Can anybody estimate for me what the loss of the investment tax credit, what the loss of an accelerated depreciation, and what the change of some of the classes of equipment in depreciation have cost the utilities over the past year since the inception of tax reform?

Mr. HUNTINGTON. I can give you the numbers from my company.

Mr. McGRATH. That is good enough.

Mr. HUNTINGTON. The loss in cashflow from the 1986 act was \$36 million a year for our company. We are roughly 1 percent of the industry, if that is any help.

Mr. McGRATH. Some of us are a little bit skeptical about changing the format which utilities operate after seeing what has happened to the service, and perhaps to some of the aspects of communications as a result of another Government interference some years back. And if I genuinely believe that the enactment is going to increase the rates of our ratepayers, then I think I have an interest in not supporting this particular endeavor. And I thank the chairman.

Mr. DORGAN. Thank you, Mr. McGrath.

Mr. Huntington and Mr. Bell, let me ask you again. You heard the testimony of the utility regulators this morning. We asked the question, is this going to, as the utility companies claim, increase your utility rates. They said, no. They are the regulators. You say, yes. You are the utility, and you have a vested interest in trying to keep that money if you possibly can.

Why should we accept your response as opposed to the regulators response? Can you give me your answer to that, Mr. Huntington?

Mr. HUNTINGTON. The statement I made is simply, I think, irrefutable. That if the excess deferred taxes for a particular company are flowed back, let us say in 3 years, which is certainly a possible outcome if your bill is enacted, the rates would clearly go down during that 3-year period. At the end of that 3-year period, they go up.

Now do they go up just to the same level they were, forgetting any other factors that affect rates for the moment? No, they go up higher. And the reason they go up more than they were before is

that excess deferred taxes are deducted from rate base in the rate-making process. And when that deduction is no longer available, then the rates are higher.

Then if you go on out through the remaining life of the assets in question, if the excess deferred taxes have all been flowed back during those first 3 years, obviously they are not available to be flowed back during the latter years. So the rates will be higher during that period than they otherwise would have been.

Now that is all I meant by my testimony. Mr. Sunley has addressed the question of when you do a present careful value analysis of that flow of revenues, as to what the results are.

Mr. DORGAN. I have made it clear that you are not at fault for where we are today. We have a policy disagreement as to what we ought to be doing with that \$19 billion. But I cannot help but feel that the arguments you make here would lead us to creating an even larger amount of excess deferred tax because you suggest that is good for the consumer. I understand why you suggest that is good for the consumer, but frankly, the consumer will benefit by having that \$19 billion in his or her pocket as soon as is possible.

Mr. HUNTINGTON. You can certainly argue that both ways as has been done at great length this morning. I think the point I wish to make is, when you look at that stream of revenues, there is not a clear benefit, present value benefit to customers of getting the money now rather than later. Now when you go beyond that and—

Mr. DORGAN. Now tell me as a customer why it is not in my interest to get that money now as opposed to 30 years from now?

Mr. HUNTINGTON. Simply that you will be paying higher rates. Now the customers who do benefit—there is one class of customers that do benefit by getting it now. And that would be large industrial customers who are currently customers of utilities but have plans within a short period of time to generate electricity themselves and cut themselves loose. Now they would get the full refund if they were returned over a short period. But then they would not be around to have to pay the increased rates later on.

So I think that class of customers clearly would benefit from this. But it would be at the expense of the remaining customers who are saddled with those high rates in the future.

Mr. DORGAN. Could one not make that case that a senior citizen will not be around to receive his full refund under normalization of the excess deferred tax?

Mr. HUNTINGTON. Yes, certainly you could make that case. But I think the tax policy that we are endorsing here by supporting the section 203(e) transition rule is that, having been collected as a tax incentive to be used to invest in plant and equipment, that money should be returned to customers in an orderly fashion over the remaining lives of the assets.

Mr. DORGAN. Mr. Bell.

Mr. BELL. I would just add to what has been said. We have calculated approximately two-thirds of the refund. The principal recipients of a gas company refund would be large industrials and commercial customers. The natural gas industry is concerned that the industrials and the large commercials might take the refund and switch to oil or to propane or another energy source.

Additionally, the NARUC figures show at least 23 of the State commissions would require crediting or refund or passthrough of the benefits on less than the life of the property. So if you then go from a 2-percent amount that was in the 1978 bill to a larger amount that we are here talking about, probably more than the 23 States would require flowthrough over a shorter period than the life of the property.

Mr. DORGAN. I would like, without objection, to include in the record the October 2 letter from Mr. Sunley to myself that I had referenced earlier in the testimony.

[The information of Mr. Dorgan follows:]

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Congressman Byron L. Dorgan
 Congress of the United States
 House of Representatives
 Washington, D.C. 20515

October 2, 1987

Dear Congressman Dorgan:

In your letter of September 21, 1987, you asked how the results we reported in Table #2 of our June 29 article in Tax Notes on normalization of utilities' excess tax reserves would be affected had we assumed an 8 percent or a 12 percent discount rate, rather than a 10 percent discount rate. The enclosed table presents those additional results. If the discount rate were 8 percent, normalization would result in a lower net present value of the utility's cost of service, a higher net present value of income taxes paid, and a lower net cost to the public than the flowthrough alternatives. If the discount rate were 12 percent, the opposite results would be obtained. In both the case of the 8 percent and the 12 percent discount rates, the differences vary less than 1 percent from the 10 percent case, a result that can be characterized as minimal.

The specification of the appropriate discount rate is, of course, a complex issue. Individuals who have savings invested at interest may have a relatively low discount rate, while borrowers may have a relatively high discount rate. Our 10 percent rate, which was based on the assumed weighted average yield of debt and equity securities issued by the utility, struck us as a reasonable resolution of that issue. This rate is the rate of return a utility customer would earn if he or she invested in the debt and equity of the utility company.

We hope that this letter addresses the questions posed by your letter and would be happy to provide you with any additional information you may need.

Sincerely,

Thomas Horst
 Thomas Horst

Emil M. Sunley
 Emil M. Sunley

Enclosure

Net Present Value of Cost of Service, Income Taxes Paid, and
Net Cost to Public, 1987-2011, Under Alternative Methods
of Restoring the Excess Tax Reserve

Net Present Value @ 10%	Normalization	One-Year Flowthrough	Three-Year Flowthrough
Cost of Service	89.97	89.48	89.53
Income Tax Paid	9.60	9.11	9.16
Net Cost to Public	80.37	80.37	80.37

Net Present Value @ 8%	Normalization	One-Year Flowthrough	Three-Year Flowthrough
Cost of Service	100.13	100.30	100.29
Income Tax Paid	11.43	11.12	11.15
Net Cost to Public	88.70	89.18	89.13

Net Present Value @ 12%	Normalization	One-Year Flowthrough	Three-Year Flowthrough
Cost of Service	81.76	80.76	80.88
Income Tax Paid	8.21	7.59	7.66
Net Cost to Public	73.55	73.17	73.22



THE CASE FOR NORMALIZING THE EXCESS TAX RESERVES OF PUBLIC UTILITIES

by Thomas Horst
and Emil M. Sunley

Thomas Horst and Emil M. Sunley are Directors in the Washington Office of Deloitte Haskins & Sells. This paper was written for the Edison Electric Institute. It offers a somewhat different view from coverage previously provided in Tax Notes (see Prior Coverage box following this article).

In this article, Horst and Sunley describe the difference between normalization and flowthrough as those terms apply to utility taxation. They point out that utility tax reserves have accrued on the assumption that the utility would pay taxes at a 46 percent rate, but that rate was cut to 34 percent by the 1986 Act. This rate cut produced excess tax reserves which through lower utility rates will be returned to customers. They argue that normalization produces the preferable result because it offers equity between customers, presents rate stability, and in the long run lowers utility costs of capital. They argue that lower taxes paid by the utility result in a higher cost to the public through the foregone taxes and that higher utility taxes are a benefit to the public. They report the results of computer runs which compare three different methods (normalization, flowthrough, and three-year amortization) of handling the excess tax reserve produced by rate reductions in the 1986 Act. They find that the net cost to the public is the same.

commission fails to "normalize" either the accelerated tax depreciation benefit arising from new investment in public utility property or the "excess tax reserve" attributable to such benefits previously claimed for existing investments in such property. This study explains what income tax normalization means in general and as applied to the excess tax reserve in particular, what the economic effects of normalization are, and why normalization continues to be appropriate as a matter of regulatory and tax policy.

What Is Tax Normalization?

The issue of tax normalization arises whenever a utility's taxable income or expenses are different from those allowed for ratemaking. Regulatory commissions generally allow utilities the opportunity to recover their cost of service, which includes current operating expenses, depreciation of capital investments, a return on invested capital net of accumulated depreciation, and an income tax allowance. When a utility invests in plant and equipment, its capital outlays for tax purposes are recovered under an accelerated method of depreciation, but for regulatory purposes, capital outlays typically are recovered under the straight-line method of depreciation over the expected life of the investment.

The issue of tax normalization arises whenever a utility's taxable income or expenses are different from those allowed for ratemaking.

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The Tax Reform Act of 1986 reduced the top corporate income tax rate from 46 to 34 percent. The Act also provided that the benefits of accelerated tax depreciation would be denied for public utility property if a regulatory

For example, suppose equipment costing \$100 having an expected useful life of 30 years and classified for tax purposes as 15-year Public Utility property under the Accelerated Cost Recovery System (ACRS) had been placed in service on July 1, 1981. Tax depreciation versus cost-of-service depreciation would be as shown in the second and third columns of Table 1. The utility would include depreciation of \$1.67 and \$3.33 in its cost of service for 1981 and 1982, respectively. However, for tax purposes, the utility would be entitled to deduct \$5.00 and \$10.00 from taxable income in 1981 and 1982, respectively. The issue arises of whether ACRS or cost-of-service depreciation should be used in calculating the amount to be charged to customers to recover the cost of the utility's income taxes. Under the "flowthrough" method, the utility's income tax allowance is based on its

tax depreciation, whereas under the "normalization" method, the income tax allowance is based on cost-of-service depreciation. That is to say, in calculating its cost of service under normalization, income taxes are calculated as if tax depreciation were based on the longer-life, straight-line method rather than the ACRS rules.

The obvious economic difference between these two methods is that until the ACRS deductions are exhausted, tax depreciation exceeds cost-of-service depreciation, so the utility's income tax allowance, all other things being equal, would be higher under the normalization method than under the flowthrough method. Thereafter, the situation is reversed with cost-of-service depreciation exceeding tax depreciation, so the income tax allowance is lower under the normalization method than under the flowthrough method. Over the life of the investment, cumulative tax depreciation equals cumulative cost-of-service depreciation (i.e., both equal the amount of the original investment), so the difference between the two methods is a timing difference, not a permanent difference.

If no other adjustments were made in the utility's cost of service, the utility would clearly prefer the normaliza-

tion method because of the time value of money benefit of collecting its income tax allowance from its customers in advance of paying income taxes to the government. The economic value of this timing difference can be measured by multiplying the cumulative difference between tax and cost-of-service depreciation by the utility's tax rate—see columns 4 through 6 in Table 1. The cumulative tax amount shown in column 6, referred to as the accumulated deferred income tax (ADIT) balance, represents the excess of the amount the utility has collected from its customers to provide for income taxes over the amount of income tax the utility actually has paid.

The utility would clearly prefer the normalization method....

Because the ADIT balance will be repaid in future years as the difference between tax and cost-of-service depreciation "reverses," the ADIT balance is recorded as a liability on the utility's balance sheet. However, unlike debt issued by the utility to its creditors, the ADIT balance is an interest-free liability. That is to say, the time value of money benefit of normalization versus flowthrough can be measured by the imputed interest on the ADIT balance.

As explained more fully below, normalization of a utility's income tax expense is advantageous as a matter of regulatory policy. To prevent the utility, however, from deriving an unintended time value of money benefit, regulatory commissions reduce the current cost of service by the imputed interest on the ADIT balance. This is typically achieved by subtracting the ADIT balance from the utility's rate base. That is to say, the return on investment included in the utility's cost of service is computed by multiplying the utility's cost of capital by the excess of its rate base over its ADIT balance. The ADIT balance is treated as if it were cost-free capital contributed by the government. By denying the utility a return on that capital, the time value of money benefit of accelerated tax depreciation ultimately accrues to the utility's customers, rather than to the utility.

Benefits of Tax Normalization

Normalization of income tax expenses has been preferred by the Congress and most regulatory commissions as a matter of regulatory policy. The principal benefits of normalization are:

Equity Among Customers. Just as it would be unfair to charge customers in the latter half of an investment's lifetime with a disproportionate share of the original capital cost of the investment, so too is it unfair to deny those customers a fair share of the benefit of accelerated tax depreciation generated by that investment. Normalization allows a proper matching over time of the income tax expense and the underlying items of income and expense giving rise to the income tax expense.

Rate Stability. If accelerated tax depreciation and other investment-related tax savings were flowed through, utility rates to customers would fluctuate with the rate of new investment. Utility rate fluctuations make it more difficult for customers to plan effectively (e.g., to determine the

Table 1

Illustration of Income Tax Normalization for \$100 Investment in Equipment With Thirty-Year Useful Life, Fifteen-Year Depreciation, and Income Tax Rate of Forty-Six Percent

Year (1)	15-Year ACRS Depreciation (2)	30-Year Straight- Line Depreciation (3)	Current Timing Difference (4)	Cumulative Timing Difference (5)	Tax Effect At 46% (6)
1981	5.00	1.87	3.33	3.33	1.53
1982	10.00	3.33	6.67	10.00	4.60
1983	9.00	3.33	5.67	15.67	7.21
1984	8.00	3.33	4.67	20.33	9.35
1985	7.00	3.33	3.67	24.00	11.04
1986	7.00	3.33	3.67	27.67	12.73
1987	6.00	3.33	2.67	30.33	13.95
1988	6.00	3.33	2.67	33.00	15.18
1989	6.00	3.33	2.67	35.67	16.41
1990	6.00	3.33	2.67	38.33	17.63
1991	6.00	3.33	2.67	41.00	18.86
1992	6.00	3.33	2.67	43.67	20.09
1993	6.00	3.33	2.67	46.33	21.31
1994	6.00	3.33	2.67	49.00	22.54
1995	6.00	3.33	2.67	51.67	23.77
1996		3.33	-3.33	48.33	22.23
1997		3.33	-3.33	45.00	20.70
1998		3.33	-3.33	41.67	19.17
1999		3.33	-3.33	38.33	16.10
2000		3.33	-3.33	35.00	14.57
2001		3.33	-3.33	31.67	13.03
2002		3.33	-3.33	28.33	11.50
2003		3.33	-3.33	25.00	9.97
2004		3.33	-3.33	21.67	8.43
2005		3.33	-3.33	18.33	6.90
2006		3.33	-3.33	15.00	5.37
2007		3.33	-3.33	11.67	3.83
2008		3.33	-3.33	8.33	2.30
2009		3.33	-3.33	5.00	0.77
2010		3.33	-3.33	1.67	0.00
2011		1.87	-1.87	0.00	0.00
Total	100.00	100.00	0.00		

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cost saving from energy conservation) and they expose the utility to the risk that regulatory commissions will be slow in restoring utility rates to reflect a higher cost of service.

Cost of Capital. Although not susceptible to precise quantification, normalization of income tax expense results in lower cost of debt and equity for the utility and, thus, lower rates for customers. Lower capital costs are obtained because: (1) the utility's cash flow is stabilized for the reasons set forth above and thus the utility's securities have lower risk, and (2) the utility's needs to raise capital in external capital markets is diminished.

Normalization...results in lower cost of debt and equity...and, thus, lower rates for customers.

Recognizing these benefits, the Congress first enacted normalization requirements in 1969 and subsequently expanded those requirements in 1971, 1975, 1981, and 1982. In the case of accelerated tax depreciation, a taxpayer is denied the benefits of accelerated ACRS depreciation with respect to public utility property if a regulatory commission fails to normalize depreciation expense. If the utility cannot claim accelerated tax depreciation, there is no tax benefit to flow through to the utility's customers.

Normalization of Excess Tax Reserve

If income tax rates remain unchanged, the ADIT balance at any point of time measures: (1) the cumulative excess of income tax expense as computed for regulatory purposes over income tax actually paid for past periods, and (2) the cumulative amount by which income tax to be paid in future periods will exceed income tax expense as computed for regulatory purposes. However, if income tax rates are reduced, the second of these two amounts will be reduced in proportion to the reduction in the tax rate. For example, the reduction in the Federal corporate income tax rate from 46 percent to 34 percent effective July 1, 1987 will reduce the Federal ADIT liability by 12/46ths. That is, when the timing differences which originally gave rise to the ADIT balance reverse, the utility's income tax expense generally will be 34/46ths of the amount projected at the time the ADIT balance was recorded. The differential between the two amounts is referred to as the excess deferred tax reserve.

Realizing that regulatory commissions would be petitioned to flow through the excess tax reserves to current customers, Congress provided in the Tax Reform Act of 1986 that the benefits of ACRS depreciation would be denied if a utility fails to normalize either the ACRS benefits arising from new investments or the recovery of its excess tax reserve.

As with other normalization requirements, normalizing the recovery of a utility's excess tax reserve does not result in an unintended windfall gain for the utility. This is demonstrated by the output from a simplified model of utility rate setting which is attached to this study. The analysis shown there makes the following assumptions:

1. A June 30 fiscal utility;¹
2. An investment of \$100 in 1981 which was placed in service in 1982;
3. ACRS depreciation for tax purposes;
4. 30 year straight-line depreciation for rate-making purposes;
5. 50 percent debt financing with a nine percent cost of debt;
6. 50 percent equity financing with an 11 percent after-tax cost of equity;
7. Debt and equity remain a fixed percentage of the rate base net of deferred taxes;
8. 46 percent corporate tax rate, FY 1981-FY 1987, and 34 percent corporate tax rate, FY 1988-FY 2011; and
9. No operating expense and no investment tax credit.

The model focuses only on the utility's cost of service as it relates to this \$100 investment over its useful life. The output of the model is shown in the Appendix. In the top third of the Appendix table, the excess deferred taxes are flowed through to customers as the timing differences which give rise to the deferred taxes reverse over the life of the asset (i.e., amortized under the average rate assumption method prescribed in the Tax Reform Act of 1986). In the middle third of the table the excess tax reserve is flowed through immediately in FY 1988 when the corporate tax rate drops to 34 percent. In the bottom third, the excess tax reserve is amortized over a three-year period starting in FY 1988.

Whether the excess deferred taxes are normalized or flowed through immediately affects the pattern of the after-tax cash flow of the utility. However, because accumulated deferred income taxes are offset against the rate base, the utility earns a constant 11 percent after-tax rate of return on invested equity under either scenario (see lines 41, 76, and 111 of the Appendix table).

What is the Public Interest?

The direct public interest in this issue can be measured by (1) the cost of service incurred by the utility and charged to the public through the utility's rates, minus (2) income taxes paid by the utility. That is to say, if under one scenario the utility pays less income tax than it does under another scenario, the income tax shortfall represents a cost to the public that should be subtracted from the differential in the cost of service when measuring the net cost to the public. This is just another way of saying that the public, not the utility's investors, bears the economic burden of the utility's income tax under the cost-of-service approach to utility ratemaking.

The accompanying chart compares the net cost to the public under each of the three alternatives mentioned above. The obvious difference between flowthrough and normalization is the sharp drop in the net cost of service during the one- or three-year period when the excess tax reserve is flowed through, followed by a higher cost of service over the remaining life of the investment.

To evaluate the public interest over an extended period of time, the utility's cost of service and taxes paid must be adjusted to reflect the time value of money. For these purposes, we have discounted both amounts by the utility's weighted average after-tax cost of capital. Table 2

¹The Tax Reform Act of 1986 reduces the corporate tax rate effective July 1, 1987. By assuming a June 30 fiscal year, the corporate income tax rate drops in a single step from 46 percent for fiscal 1987 to 34 percent for fiscal 1988.

shows the present value of cost of service, income taxes paid, and net cost to the public for 1987-2011 under alternative methods of restoring the excess tax reserve: normalization, one-year flowthrough, and three-year flowthrough.

Note that while the net present value of the utility's cost of service and income taxes paid varies slightly, the variation is relatively small. More significantly, the net cost to the public is identical under each of the three methods because variations in the net present value of the utility's cost of service are attributable to, and offset by, the income taxes paid by the utility.

The preceding analysis is predicated on the assumption that the utility's cost of capital is not affected by the method used to restore the excess tax reserve to the cost of service. However, under a flowthrough method, a utility would have to issue new debt and equity to refinance over a period of one to three years the entire excess tax reserve resulting from the reduction of the corporate income tax rate from 46 percent to 34 percent. If a large number of utilities had to issue such debt and equity within the same one- to three-year interval, the impact on utilities' cost of capital and thus their cost of service could be significant.

Table 2

Net Present Value of Cost of Service, Income Taxes Paid, and Net Cost to Public, 1987-2011, Under Alternative Methods of Restoring the Excess Tax Reserve

Net Present Value of:	Normalization	One-Year Flowthrough	Three-Year Flowthrough
Cost of Service	89.97	89.48	89.53
Income Tax Paid	9.50	9.11	9.16
Net Cost to Public	80.37	80.37	80.37

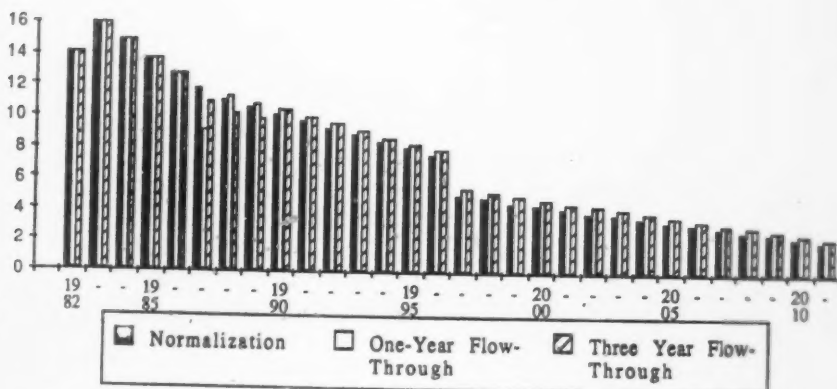
If the discount rate is held constant, any increase in the utility's cost of capital under the flowthrough method would result in a higher net cost to the public than the net cost would be under normalization. Moreover, if the cost of debt and equity are both increased by 15 basis points or more, the net present value of the utility's cost of service would be higher under the flowthrough than under the normalization method. So while the impact of flowthrough on the utility's cost of capital cannot be quantified with any precision, even a relatively small impact would result in utility customers bearing a cost of service with a higher net present value than that arising under the normalization method.

If...the utility pays less income tax...the ... shortfall represents a cost to the public....

Conclusion

In summary, normalization of a utility's excess tax reserve under the average rate assumption method results in neither a windfall gain for utilities nor a windfall burden for customers. By spreading the recovery of the excess tax reserve over the lives of the utilities' investments which gave rise to the excess tax reserve, normalization treats customers equitably over time and avoids sharp fluctuations in utility rates. The net cost to the public when measured in present value terms is the same under normalization and flowthrough if the utilities' after-tax cost of capital is the same under both normalization and flowthrough. Normalization, however, reduces utilities' need to raise new capital by issuing new debt and equity, thus reducing utilities' cost of capital. This reduction would result in lower net cost to the public.

Net Cost to Public Under Alternative Methods



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Appendix
Taxable Year Starting July 1:

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
1 Net Property in Service EOY	0.0	100.0	96.7	93.3	90.0	86.7	83.3	80.0	76.7	73.3	70.0	66.7	63.3	60.0	56.7
2 New Investment	100.0														
3 Book Depreciation	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
4 Net Property in Service EOY	100.0	96.7	93.3	90.0	86.7	83.3	80.0	76.7	73.3	70.0	66.7	63.3	60.0	56.7	53.3
5 ACRS Factors (15-Year Property)	0%	10%	9%	8%	7%	7%	6%	6%	6%	6%	6%	6%	6%	6%	6%
6 ACRS Depreciation	0.0	10.0	9.0	8.0	7.0	7.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
ACCUMULATED DEFERRED INCOME TAX (ADIT) — AVERAGE RATE METHOD															
7 ADIT Balance—BOY	0.0	0.8	3.8	8.4	8.8	10.3	11.5	12.4	13.3	14.2	15.1	16.1	16.1	17.0	17.9
8 Cumulative Book-Tax Difference—BOY	0.0	1.7	8.3	14.0	18.7	22.3	26.0	28.7	31.3	34.0	36.7	39.3	42.0	44.7	
9 Current Book-Tax Difference	1.7	6.7	5.7	4.7	3.7	3.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
10 Cumulative Book-Tax Difference—EOY	1.7	8.3	14.0	18.7	22.3	26.0	28.7	31.3	34.0	36.7	39.3	42.0	44.7	47.3	
11 Tax Rate	46%	46%	46%	46%	46%	46%	34%	34%	34%	34%	34%	34%	34%	34%	34%
12 ADIT Addition	0.8	3.1	2.6	2.1	1.7	1.2	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
13 Tentative ADIT Balance—EOY	0.8	3.8	6.4	8.8	10.3	11.5	12.4	13.3	14.2	15.1	16.1	17.0	17.9	18.8	
14 Addition to Excess Tax Reserve					0.0	0.0	0.0	2.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Average Tax Rate—BOY					46.0%	46.0%	46.0%	44.3%	43.3%	42.6%	41.9%	41.3%	40.8%	40.4%	40.0%
16 Excess Average Tax Rate					0%	0%	0%	12%	10%	9%	9%	8%	7%	6%	6%
17 Reversal of timing difference					0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
18 Amortization of Excess Tax Reserve					0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
19 ADIT Balance—EOY	0.8	3.8	6.4	8.8	10.3	11.5	12.4	13.3	14.2	15.1	16.1	17.0	17.9	18.8	
20 Rate Base—BOY	100.0	95.9	89.5	83.8	78.1	73.1	68.9	64.2	60.0	55.9	51.5	47.3	43.0	38.8	
21 Embedded Debt	50.0	48.0	44.8	41.8	39.0	36.5	34.2	32.1	30.0	27.9	25.8	23.8	21.8	19.4	
22 Cost of Debt	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%
23 Interest Expense	4.5	4.3	4.0	3.8	3.5	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	
24 Equity	50.0	48.0	44.8	41.8	39.0	36.5	34.2	32.1	30.0	27.9	25.8	23.8	21.8	19.4	
25 Equity Rate of Return (After-Tax)	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%
26 Equity Return	5.5	5.3	4.9	4.6	4.3	4.0	3.8	3.5	3.3	3.1	2.9	2.8	2.4	2.1	
27 Income Tax Base	5.5	5.3	4.9	4.6	4.3	4.0	3.8	3.5	3.3	3.1	2.8	2.6	2.4	2.1	
28 Income Tax Rate	46%	46%	46%	46%	46%	46%	34%	34%	34%	34%	34%	34%	34%	34%	34%
29 Gross-Up Factor	0.8519	0.8519	0.8519	0.8519	0.8519	0.8519	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152
30 Income Tax Allowance	4.7	4.5	4.2	3.9	3.7	3.1	1.9	1.8	1.7	1.6	1.5	1.3	1.2	1.1	
31 Cost of Service	18.0	17.4	16.5	15.6	14.8	12.7	12.1	11.6	11.0	10.5	9.9	9.4	8.9	8.3	
32 Taxable Income	8.5	3.1	3.4	3.8	4.3	2.4	3.0	2.7	2.3	2.0	1.8	1.5	0.9	0.6	
33 Income Tax Paid	3.9	1.4	1.6	1.8	2.0	0.8	1.0	0.9	0.8	0.7	0.6	0.4	0.3	0.2	
34 Add to Deferred Tax	0.8	3.1	2.8	2.1	1.7	1.2	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	
35 Net Cost to Public	14.1	16.0	14.9	13.8	12.8	11.8	11.1	10.7	10.2	9.8	9.4	9.0	8.5	8.1	
36 Utility's After-Tax Cash Flow	-100.0	14.1	18.0	14.9	13.8	12.8	11.8	11.1	10.7	10.2	9.8	9.4	9.0	8.5	8.1
37 Debt Service Cash Flow	-80.0	8.5	7.5	7.0	6.5	6.0	5.6	5.2	5.0	4.8	4.6	4.4	4.2	4.1	3.9
38 Cash Flow to Equity	-90.0	7.6	9.5	7.9	7.3	6.8	6.3	5.9	5.7	5.4	5.2	5.0	4.7	4.5	4.3
CALCULATED INTERNAL RATES OF RETURN															
39 Cash Flow to All Investors															
40 Cash Flow to Debt Holders															
41 Cash Flow to Equity Investors															
NET PRESENT VALUE @ 10%															
42 Cost of Service, FY1980-2012															89.97
43 Income Tax Paid, FY1980-2012															9.80
44 Net Cost to Public, FY1980-2012															80.37
ACCUMULATED DEFERRED INCOME TAX (ADIT)—ONE-YEAR FLOWTHROUGH METHOD															
45 ADIT Balance—BOY	0.0	0.8	3.8	8.4	8.8	10.3	8.8	9.7	10.7	11.8	12.5	13.4	14.3	15.2	
46 Cumulative Book-Tax Difference—BOY	0.0	1.7	8.3	14.0	18.7	22.3	26.0	28.7	31.3	34.0	36.7	39.3	42.0	44.7	
47 Current Book-Tax Difference	1.7	6.7	5.7	4.7	3.7	3.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
48 Cumulative Book-Tax Difference—EOY	1.7	8.3	14.0	18.7	22.3	26.0	28.7	31.3	34.0	36.7	39.3	42.0	44.7	47.3	
49 Tax Rate	46%	46%	46%	46%	46%	46%	34%	34%	34%	34%	34%	34%	34%	34%	34%
50 ADIT Addition	0.8	3.1	2.8	2.1	1.7	1.2	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
51 Tentative ADIT Balance—EOY	0.8	3.8	6.4	8.8	10.3	11.5	9.7	10.7	11.8	12.5	13.4	14.3	15.2	16.1	
52 Addition to Excess Tax Reserve					0.0	0.0	0.0	2.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
53 Amortization of Excess Tax Reserve					0.0	0.0	0.0	2.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
54 ADIT Balance—EOY	0.8	3.8	6.4	8.8	10.3	11.5	9.7	10.7	11.8	12.5	13.4	14.3	15.2	16.1	
55 Rate Base—BOY	100.0	95.9	89.5	83.8	78.1	73.1	71.2	68.9	62.7	58.4	54.2	50.0	45.7	41.5	
56 Embedded Debt	50.0	48.0	44.8	41.8	39.0	36.5	35.8	33.5	31.3	29.2	27.1	25.0	22.9	20.7	
57 Interest Rate	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%
58 Interest Expense	4.5	4.3	4.0	3.8	3.5	3.3	3.2	3.0	2.8	2.6	2.4	2.2	2.1	1.9	
59 Equity	50.0	48.0	44.8	41.8	39.0	36.5	35.8	33.5	31.3	29.2	27.1	25.0	22.9	20.7	
60 Equity Return (After-Tax)	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%

Taxable Year Starting July 1:

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
1 Net Property In Service BOY	53.3	50.0	46.7	43.3	40.0	36.7	33.3	30.0	26.7	23.3	20.0	16.7	13.3	10.0	6.7	3.3
3 Book Depreciation	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
4 Net Property In Service EOY	50.0	46.7	43.3	40.0	36.7	33.3	30.0	26.7	23.3	20.0	16.7	13.3	10.0	6.7	3.3	0.0
5 ACRS Factors (15-Year Property)	8%															
6 ACRS Depreciation	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0

ACCUMULATED DEFERRED INCOME TAX (ADIT) — AVERAGE RATE METHOD

7 ADIT Balance—BOY	18.8	19.7	18.4	17.1	15.7	14.4	13.1	11.8	10.5	9.2	7.9	6.6	5.2	3.9	2.6	1.3
8 Cumulative Book-Tax Difference—BOY	47.3	50.0	46.7	43.3	40.0	36.7	33.3	30.0	26.7	23.3	20.0	16.7	13.3	10.0	6.7	3.3
9 Current Book-Tax Difference	2.7	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3
10 Cumulative Book-Tax Difference—EOY	50.0	46.7	43.3	40.0	36.7	33.3	30.0	26.7	23.3	20.0	16.7	13.3	10.0	6.7	3.3	0.0
11 Tax Rate	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%
12 ADIT Addition	0.9	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
13 Tentative ADIT Balance—EOY	19.7	18.5	17.2	15.9	14.6	13.3	12.0	10.7	9.4	8.1	6.7	5.4	4.1	2.8	1.5	0.2
14 Addition to Excess Tax Reserve	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Average Tax Rate—BOY	39.7%	39.4%	39.4%	39.4%	39.4%	39.4%	39.4%	39.4%	39.4%	39.4%	39.4%	39.4%	39.4%	39.4%	39.4%	39.4%
16 Excess Average Tax Rate	6%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
17 Reversal of timing difference	0.0	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
18 Amortization of Excess Tax Reserve	0.0	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
19 ADIT Balance—EOY	19.7	18.4	17.1	15.7	14.4	13.1	11.8	10.5	9.2	7.9	6.6	5.2	3.9	2.6	1.3	0.0
20 Rate Base—BOY	34.6	30.3	26.3	26.3	24.3	22.2	20.2	18.2	16.2	14.1	12.1	10.1	8.1	6.1	4.0	2.0
21 Embedded Debt	17.3	15.2	14.1	13.1	12.1	11.1	10.1	9.1	8.1	7.1	6.1	5.1	4.0	3.0	2.0	1.0
22 Cost of Debt	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%
23 Interest Expense	1.6	1.4	1.3	1.2	1.1	1.0	0.9	0.8	0.7	0.6	0.5	0.4	0.3	0.2	0.1	0.0
24 Equity	17.3	15.2	14.1	13.1	12.1	11.1	10.1	9.1	8.1	7.1	6.1	5.1	4.0	3.0	2.0	1.0
25 Equity Rate of Return (After-Tax)	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%
26 Equity Return	1.9	1.7	1.6	1.4	1.3	1.2	1.1	1.0	0.9	0.8	0.7	0.6	0.4	0.3	0.2	0.1
27 Income Tax Base	1.9	1.5	1.4	1.3	1.2	1.0	0.9	0.8	0.7	0.6	0.5	0.4	0.3	0.2	0.1	0.0
28 Income Tax Rate	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%
29 Gross-Up Factor	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152
30 Income Tax Allowance	1.0	0.8	0.7	0.7	0.6	0.5	0.5	0.4	0.4	0.3	0.3	0.2	0.1	0.1	0.0	0.0
31 Cost of Service	7.8	7.0	6.7	6.4	6.2	5.9	5.7	5.4	5.1	4.9	4.6	4.4	4.1	3.8	3.6	3.3
32 Taxable Income	0.2	5.8	5.4	5.3	5.1	4.9	4.7	4.6	4.4	4.2	4.1	3.9	3.7	3.6	3.4	3.2
33 Income Tax Paid	0.1	1.9	1.8	1.7	1.7	1.6	1.6	1.5	1.4	1.4	1.3	1.3	1.2	1.2	1.1	1.1
34 Add to Deferred Tax	0.9	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
35 Net Cost to Public	7.7	5.1	4.9	4.6	4.4	4.2	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6	2.4	2.2
36 Utility's After-Tax Cash Flow	7.7	5.1	4.9	4.6	4.4	4.2	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6	2.4	2.2
37 Debt Service Cash Flow	3.7	2.4	2.3	2.2	2.1	2.0	1.9	1.8	1.7	1.6	1.5	1.4	1.3	1.2	1.1	1.0
38 Cash Flow to Equity	4.0	2.7	2.6	2.5	2.3	2.2	2.1	2.0	1.9	1.8	1.7	1.6	1.5	1.3	1.2	1.1

ACCUMULATED DEFERRED INCOME TAX (ADIT) — ONE-YEAR FLOWTHROUGH METHOD

45 ADIT Balance—BOY	18.1	17.0	15.9	14.7	13.6	12.5	11.3	10.2	9.1	7.9	6.8	5.7	4.6	3.4	2.3	1.1
46 Cumulative Book-Tax Difference—BOY	47.3	50.0	46.7	43.3	40.0	36.7	33.3	30.0	26.7	23.3	20.0	16.7	13.3	10.0	6.7	3.3
47 Current Book-Tax Difference	2.7	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3
48 Cumulative Book-Tax Difference—EOY	50.0	46.7	43.3	40.0	36.7	33.3	30.0	26.7	23.3	20.0	16.7	13.3	10.0	6.7	3.3	0.0
49 Tax Rate	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%
50 ADIT Addition	0.9	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
51 Tentative ADIT Balance—EOY	17.0	15.9	14.7	13.6	12.5	11.3	10.2	9.1	7.9	6.8	5.7	4.6	3.4	2.3	1.1	0.0
52 Addition to Excess Tax Reserve	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
53 Amortization of Excess Tax Reserve	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
54 ADIT Balance—EOY	17.0	15.9	14.7	13.6	12.5	11.3	10.2	9.1	7.9	6.8	5.7	4.6	3.4	2.3	1.1	0.0
55 Rate Base—BOY	37.2	33.0	30.8	28.6	26.4	24.2	22.0	19.8	17.6	15.4	13.2	11.0	8.8	6.6	4.4	2.2
56 Embedded Debt	18.6	16.5	15.4	14.3	13.2	12.1	11.0	9.9	8.8	7.7	6.6	5.5	4.4	3.3	2.2	1.1
57 Interest Rate	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%
58 Interest Expense	1.7	1.5	1.4	1.3	1.2	1.1	1.0	0.9	0.8	0.7	0.6	0.5	0.4	0.3	0.2	0.1
59 Equity	18.6	16.5	15.4	14.3	13.2	12.1	11.0	9.9	8.8	7.7	6.6	5.5	4.4	3.3	2.2	1.1
60 Equity Return (After-Tax)	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%

SPECIAL REPORTS

Appendix (Continued)
Taxable Year Starting July 1: (Continued)

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
61 Return	5.5	5.3	4.9	4.8	4.3	4.0	3.9	3.7	3.4	3.2	3.0	2.7	2.5	2.3	2.3
62 Income Tax Base	5.5	5.3	4.9	4.8	4.3	4.0	3.9	3.7	3.4	3.2	3.0	2.7	2.5	2.3	2.3
63 Income Tax Rate	46%	46%	46%	46%	46%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%
64 Gross-Up Factor	0.8519	0.8519	0.8519	0.8519	0.8519	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152
65 Income Tax Allowance	4.7	4.5	4.2	3.9	3.7	3.7	2.0	1.9	1.8	1.7	1.5	1.4	1.3	1.2	1.2
66 Cost of Service	18.0	17.4	16.5	15.6	14.8	9.8	12.5	11.9	11.4	10.8	10.3	9.7	9.2	8.7	8.4
67 Taxable Income	8.5	3.1	3.4	3.8	4.3	-1.8	3.3	2.9	2.6	2.2	1.9	1.5	1.1	0.8	0.8
68 Income Tax Paid	3.9	1.4	1.6	1.8	2.0	-0.6	1.1	1.0	0.9	0.7	0.6	0.5	0.4	0.3	0.3
69 Add to Deferred Tax	0.8	3.1	2.6	2.1	1.7	1.2	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
70 Net Cost to Public	14.1	16.0	14.9	13.8	12.8	9.2	11.4	10.9	10.5	10.1	9.7	9.2	8.8	8.4	8.4
71 Utility's After-Tax Cash Flow	-100.0	14.1	16.0	14.9	13.8	12.8	9.2	11.4	10.9	10.5	10.1	9.7	9.2	8.8	8.4
72 Cash Flow to Debt Holders	-50.0	6.5	7.5	7.0	6.5	8.0	5.1	4.8	4.5	4.7	4.6	4.4	4.2	4.0	4.0
73 Cash Flow to Equity Investors	-50.0	7.6	8.5	7.9	7.3	6.8	5.0	6.0	5.8	5.6	5.3	5.1	4.9	4.6	4.4
CALCULATED INTERNAL RATES OF RETURN															
74 After-Tax Cash Flow	10.0%														
75 Debt Service Cash Flow	9.0%														
76 Cash Flow to Equity	11.0%														
NET PRESENT VALUE @ 10.0%															
77 Cost of Service, FY1988-2012	89.48														
78 Income Tax Paid, FY1988-2012	9.11														
79 Net Cost to Public, FY1988-2012	80.37														

ACCUMULATED DEFERRED INCOME TAX (ADIT)—THREE-YEAR FLOWTHROUGH METHOD

80 ADIT Balance—BOY	0.0	0.8	3.8	8.4	8.8	10.3	10.6	10.8	10.7	11.8	12.5	13.4	14.3	15.2	
81 Cumulative Book-Tax Difference—BOY	0.0	1.7	8.3	14.0	18.7	22.3	26.0	28.7	31.3	34.0	36.7	39.3	42.0	44.7	
82 Current Book-Tax Difference	1.7	6.7	5.7	4.7	3.7	3.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	
83 Cumulative Book-Tax Difference—EOY	1.7	8.3	14.0	18.7	22.3	26.0	28.7	31.3	34.0	36.7	39.3	42.0	44.7	47.3	
84 Tax Rate	46%	46%	46%	46%	46%	34%	34%	34%	34%	34%	34%	34%	34%	34%	
85 ADIT Addition	0.8	3.1	2.6	2.1	1.7	1.2	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	
86 Tentative ADIT Balance—EOY	0.8	3.8	6.4	8.6	10.3	11.5	11.5	11.8	12.5	13.4	14.3	15.2	16.1		
87 Addition to Excess Tax Reserve				0.0	0.0	0.0	2.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
88 Amortization of Excess Tax Reserve				0.0	0.0	0.0	0.9	0.9	0.0	0.0	0.0	0.0	0.0	0.0	
89 ADIT Balance—EOY	0.8	3.8	6.4	8.6	10.3	10.6	10.8	10.7	11.6	12.5	13.4	14.3	15.2	16.1	
90 Rate Base—BOY	100.0	95.9	89.5	83.8	78.1	73.1	69.4	66.0	62.7	58.4	54.2	50.0	45.7	41.5	
91 Embedded Debt	50.0	48.0	44.8	41.8	39.0	36.5	34.7	33.0	31.3	29.2	27.1	25.0	22.9	20.7	
92 Interest Rate	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	
93 Interest Expense	4.5	4.3	4.0	3.8	3.5	3.3	3.1	3.0	2.8	2.6	2.4	2.2	2.1	1.9	
94 Equity	50.0	48.0	44.8	41.8	39.0	36.5	34.7	33.0	31.3	29.2	27.1	25.0	22.9	20.7	
95 Equity Return (After-Tax)	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	
96 Return	5.5	5.3	4.9	4.8	4.3	4.0	3.8	3.6	3.4	3.2	3.0	2.7	2.5	2.3	
97 Income Tax Base	5.5	5.3	4.9	4.8	4.3	4.0	3.9	3.7	3.4	3.2	3.0	2.7	2.5	2.3	
98 Income Tax Rate	46%	46%	46%	46%	46%	34%	34%	34%	34%	34%	34%	34%	34%	34%	
99 Gross-Up Factor	0.8519	0.8519	0.8519	0.8519	0.8519	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	
100 Income Tax Allowance	4.7	4.5	4.2	3.9	3.7	3.7	1.8	1.5	1.4	1.3	1.2	1.1	1.0	0.9	
101 Cost of Service	18.0	17.4	16.5	15.6	14.8	11.4	10.9	10.5	11.4	10.8	10.3	9.7	9.2	8.7	
102 Taxable Income	8.5	3.1	3.4	3.8	4.3	-1.8	3.3	2.9	2.6	2.2	1.9	1.5	1.1	0.8	
103 Income Tax Paid	3.9	1.4	1.6	1.8	2.0	0.4	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	
104 Add to Deferred Tax	0.8	3.1	2.6	2.1	1.7	1.2	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	
105 Net Cost to Public	14.1	16.0	14.9	13.8	12.8	11.0	10.3	9.9	10.5	10.1	9.7	9.2	8.8	8.4	
106 Utility's After-Tax Cash Flow	-100.0	14.1	16.0	14.9	13.8	12.8	11.0	10.3	9.9	10.5	10.1	9.7	9.2	8.8	8.4
107 Cash Flow to Debt Holders	-50.0	6.5	7.5	7.0	6.5	8.0	5.1	4.8	4.5	4.7	4.6	4.4	4.2	4.0	
108 Cash Flow to Equity Investors	-50.0	7.6	8.5	7.9	7.3	6.8	5.0	5.5	5.3	5.6	5.3	5.1	4.9	4.6	4.4
CALCULATED INTERNAL RATES OF RETURN															
109 After-Tax Cash Flow	10.0%														
110 Debt Service Cash Flow	9.0%														
111 Cash Flow to Equity	11.0%														
NET PRESENT VALUE @ 0.100															
112 Cost of Service, FY1988-2012	89.53														
113 Income Tax Paid, FY1988-2012	9.16														
114 Net Cost to Public, FY1988-2012	80.37														

PRIOR COVERAGE

Tax Notes has provided coverage of the normalization issue in the following special reports, letters and news stories:

"The Effect of Tax Reform on Public Utilities," by Donald W. Kiefer, June 1, 1987, p. 899.

"Battle Lines Drawn Over Dorgan's Normalization Bill," by Tim N. Vettel, June 1, 1987, p. 825.

"Dorgan Would Shorten Utility Normalization Period," by Mark F. Johnson, February 9, 1987, p. 535.

Taxable Year Starting July 1: (Continued)

	1990	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
81 Return	2.0	1.9	1.7	1.8	1.8	1.3	1.2	1.1	1.0	0.8	0.7	0.6	0.5	0.4	0.2	0.1
82 Income Tax Base	2.0	1.8	1.7	1.8	1.8	1.3	1.2	1.1	1.0	0.8	0.7	0.6	0.5	0.4	0.2	0.1
83 Income Tax Rate	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%
84 Gross-Up Factor	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152
85 Income Tax Allowance	1.1	0.9	0.9	0.8	0.7	0.7	0.6	0.6	0.5	0.4	0.4	0.3	0.2	0.2	0.1	0.1
86 Cost of Service	8.1	7.8	7.3	7.0	6.7	6.4	6.2	5.9	5.6	5.3	5.0	4.7	4.5	4.2	3.9	3.6
87 Taxable Income	3.5	3.1	2.9	2.7	2.5	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	0.9	0.7	0.5
88 Income Tax Paid	0.1	2.1	2.0	1.9	1.8	1.8	1.7	1.6	1.5	1.4	1.3	1.2	1.1	1.0	0.9	0.8
89 Add to Deferred Tax	0.9	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
90 Net Cost to Public	8.0	5.5	5.3	5.1	4.8	4.6	4.4	4.2	4.0	3.7	3.5	3.3	3.1	2.9	2.6	2.4
91 Utility's After-Tax Cash Flow	8.0	5.5	5.3	5.1	4.8	4.6	4.4	4.2	4.0	3.7	3.5	3.3	3.1	2.9	2.6	2.4
92 Cash Flow to Debt Holders	3.8	2.8	2.5	2.4	2.3	2.2	2.1	2.0	1.9	1.8	1.7	1.6	1.5	1.4	1.3	1.2
93 Cash Flow to Equity Investors	4.2	2.9	2.8	2.7	2.5	2.4	2.3	2.2	2.1	1.9	1.8	1.7	1.6	1.5	1.3	1.2

ACCUMULATED DEFERRED INCOME TAX (ADIT)—THREE-YEAR FLOWTHROUGH METHOD

80 ADIT Balance—BOY	18.1	17.0	15.9	14.7	13.6	12.5	11.3	10.2	9.1	7.9	6.8	5.7	4.5	3.4	2.3	1.1
81 Cumulative Book-Tax Difference—BOY	47.3	50.0	48.7	42.3	40.0	38.7	33.3	30.0	28.7	23.3	20.0	18.7	13.3	10.0	8.7	3.2
82 Current Book-Tax Difference	2.7	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3	-3.3
83 Cumulative Book-Tax Difference—EOY	50.0	46.7	43.3	40.0	36.7	33.3	30.0	26.7	23.3	20.0	16.7	13.3	10.0	6.7	3.3	0.0
84 Tax Rate	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%
85 ADIT Addition	0.9	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
86 Tentative ADIT Balance—EOY	17.0	15.9	14.7	13.6	12.5	11.3	10.2	9.1	7.9	6.8	5.7	4.5	3.4	2.3	1.1	0.0
87 Addition to Excess Tax Reserve	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
88 Amortization of Excess Tax Reserve	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
89 ADIT Balance—EOY	17.0	15.9	14.7	13.6	12.5	11.3	10.2	9.1	7.9	6.8	5.7	4.5	3.4	2.3	1.1	0.0
90 Rate Base—BOY	37.2	33.0	30.8	28.6	26.4	24.2	22.0	19.8	17.6	15.4	13.2	11.0	8.8	6.6	4.4	2.2
91 Embedded Debt	18.6	16.5	15.4	14.3	13.2	12.1	11.0	9.9	8.8	7.7	6.6	5.5	4.4	3.3	2.2	1.1
92 Interest Rate	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%
93 Interest Expense	1.7	1.5	1.4	1.3	1.2	1.1	1.0	0.9	0.8	0.7	0.6	0.5	0.4	0.3	0.2	0.1
94 Equity	18.6	16.5	15.4	14.3	13.2	12.1	11.0	9.9	8.8	7.7	6.6	5.5	4.4	3.3	2.2	1.1
95 Equity Return (After-Tax)	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%
96 Return	2.0	1.8	1.7	1.6	1.5	1.3	1.2	1.1	1.0	0.8	0.7	0.6	0.5	0.4	0.2	0.1
97 Income Tax Base	2.0	1.8	1.7	1.6	1.5	1.3	1.2	1.1	1.0	0.8	0.7	0.6	0.5	0.4	0.2	0.1
98 Income Tax Rate	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%
99 Gross-Up Factor	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152	0.5152
100 Income Tax Allowance	1.1	0.9	0.9	0.8	0.7	0.7	0.6	0.6	0.5	0.4	0.4	0.3	0.2	0.2	0.1	0.1
101 Cost of Service	8.1	7.8	7.3	7.0	6.7	6.4	6.2	5.9	5.6	5.3	5.0	4.7	4.5	4.2	3.9	3.6
102 Taxable Income	2.4	2.1	2.0	1.9	1.8	1.8	1.7	1.6	1.5	1.4	1.3	1.2	1.1	1.0	0.9	0.8
103 Income Tax Paid	0.1	2.1	2.0	1.9	1.8	1.8	1.7	1.6	1.5	1.4	1.3	1.2	1.1	1.0	0.9	0.8
104 Add to Deferred Tax	0.9	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
105 Net Cost to Public	8.0	5.5	5.3	5.1	4.8	4.6	4.4	4.2	4.0	3.7	3.5	3.3	3.1	2.9	2.6	2.4
106 Utility's After-Tax Cash Flow	8.0	5.5	5.3	5.1	4.8	4.6	4.4	4.2	4.0	3.7	3.5	3.3	3.1	2.9	2.6	2.4
107 Cash Flow to Debt Holders	3.8	2.8	2.5	2.4	2.3	2.2	2.1	2.0	1.9	1.8	1.7	1.6	1.5	1.4	1.3	1.2
108 Cash Flow to Equity Investors	4.2	2.9	2.8	2.7	2.5	2.4	2.3	2.2	2.1	1.9	1.8	1.7	1.6	1.5	1.3	1.2





SPECIAL REPORT

EXCESS TAX RESERVES AND THE TAX REFORM ACT OF 1986

by Joseph W. Jacobs
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In this article, the authors discuss recent congressional efforts to repeal section 203(e) of the Tax Reform Act of 1986. It prevents utilities from accelerating the return to ratepayers of "excess tax reserves" that were created by the Act's reduction in corporation tax rates. They also point out that congressional guidance is needed to prevent the continued accrual of excess tax reserves.

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Introduction

On February 9, 1987, Representative Byron Dorgan, D-N.Dak., introduced a bill entitled the "Utility Ratepayer Refund Act of 1987."¹ The bill's title suggests a design to give the nation's ratepayers refunds on their utility bills, presumably paid for by the Federal government. In fact, Congressman Dorgan's bill would place no demand on the Federal fisc despite the fact that a utility rate refund of some \$20 billion would likely follow if his bill were to become law. Mr. Dorgan's bill does just one thing: it would repeal section 203(e) of the Tax Reform Act of 1986. This generally obscure provision is not even codified in the 1986 Code. It operates to limit the discretion of state utility regulatory commissions to set rates reflecting the tax savings to be realized by utilities under the new,

lower tax rates. Technically, section 203(e) added a new hoop through which regulators must jump in order to insure that the rates which they set reflect a "normalization method of accounting."

Historical Background

Normalization springs from depreciation: more particularly, from the differing allowances for depreciation used, on the one hand, by regulatory commissions in setting utility rates, and on the other by utility accountants in calculating Federal income tax liability. To illustrate this difference and the ratemaking controversy arising out of this difference, suppose that a group of investors amass \$1 billion to purchase a machine which will produce electricity. This machine has a peculiar feature: it will, without fuel or maintenance, produce 100 continuous megawatts of electrical power for exactly 50 years, whereupon it will disintegrate.

Section 203(e) of the Tax Reform Act of 1986... is not even codified in the 1986 Code.

A public utility commission charged with setting rates for this enterprise would begin by determining what is a fair rate of return on the \$1 billion supplied by investors. Having ascertained, for example, that 10 percent is such a "fair" rate of return, the commission would set the price of electricity generated by the enterprise at a level such that \$100 million (a 10 percent return on the rate base of \$1 billion) would be available for distribution to the investors once all the bills are paid. Mechanically this is accomplished by adding to this desired bottom line return an allowance for "Cost of Service," that is, the anticipated costs which the enterprise would incur in rendering its electrical generating service. The result is the enterprise's "Revenue Requirement."

Two expenses of operation are germane to the normalization controversy. First, if the investors are to receive \$100 million, there must be an allowance for the Federal income tax imposed on the enterprise. Assuming a 50 percent tax rate, pre-tax earnings of \$200 million would be needed to net investors \$100 million after tax. In regulatory parlance, the \$100 million target return must

¹H.R. 1049, 100th Congress, 1st Sess. (1987).

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be "grossed up" to reflect taxes and the tax on tax effect.² Second, if the investors are to be persuaded to invest in the enterprise, regulators must assure them not only a return on their \$1 billion investment, but also the return of the investment. This return of investment is effected by figuring a depreciation allowance using a straight-line calculation over the machine's economic useful life, and then treating the annual allowance as a cost of service reflected in the rates. Here, regulators would allow an annual depreciation deduction of \$1 billion/50 years = \$20 million per year. The enterprise's annual revenue requirement would be: \$100 million (the return on investment) + \$100 million (assumed tax expense) + \$20 million (depreciation allowance) = \$220 million. To complete the picture, the rate base in year 2 would be decreased by year 1's depreciation allowance, reflecting the fact that two percent of the original investment had already been recovered.

In regulatory parlance, the . . . target return [on investment] must be 'grossed up' to reflect taxes. . . .

Until the advent of the 1954 Code, depreciation for tax purposes was figured in basically the same way. Only a straight-line method was generally allowable, permitting a recovery of investment ratably over the asset's estimated useful life, taking into account salvage value at the end of the estimated useful life. Book and tax depreciation, then, would generally be the same: \$20 million as illustrated by the example.

In 1954, however, accelerated depreciation was first offered for tax purposes as an alternative to straight-line depreciation.³ A now-familiar fiscal explanation was offered to support the concept: faster depreciation produces lower current tax payments and thus stimulates investment in the means of production.⁴ This same rationale was to support a trend towards ever accelerating methods of depreciation, culminating in the "ACRS" system in 1981.⁵ Today, hyper-accelerated depreciation methods (where the cost recovery period is unrelated to the useful life of the asset) has become the norm for tax purposes. For ratemaking purposes, however, use of straight-line depreciation remains universal. The result is a substantial spread between the book and tax income of regulated utilities, the former being substantially higher.

The disparity between book and tax depreciation creates a thorny regulatory problem. Returning to the previous example, assume that the 1986 Code permits the enterprise to claim 10-year straight-line cost recovery deductions on the \$1 billion machine. For the first 10 years of operation, it can be seen that a revenue requirement of only \$140 million would produce funds sufficient to give the enterprise: a \$100 million return on investment; a \$20 million return of investment; and the \$20 million needed by pay income tax on taxable income of \$40 million (gross income of \$140 million less the \$100 million ACRS deduction). This is \$80 million per year less than the revenue requirement of \$220 million where straight-line depreciation is used for both book and the tax purposes. But this \$80 million annual savings is arguably misleading. Beginning in year 11 (when the cost basis of the asset has been fully recovered and the tax depreciation becomes 0) a revenue requirement of \$240 million per year would be needed to produce the approved return on investment, and to pay the tax expense of \$120 million (50 percent of the gross income of \$240 million less a tax depreciation deduction of 0). The \$80 million rate savings becomes a \$20 million rate surcharge.

Two schools of regulatory thought emerged as commissions sought to resolve this issue. The "normalization" school stressed that only temporary timing differences resulted from using accelerated depreciation. Over the life of the asset, the total depreciation deductions and thus the total tax payments (ignoring changes in the tax rates) were the same under any depreciation method. The normalization school focused on an intergenerational inequity which would occur upon "reverse," the point at which regulatory depreciation would begin to exceed accelerated tax depreciation. Under our example, reversal would occur in year 11, when the annual revenue requirement of \$140 million would increase 71 percent to \$240 million. Tomorrow's ratepayers, the argument went, should not be called upon to fund an advantage given today's ratepayers. To avoid this result, the normalization school argued that rates should be set by ignoring the timing difference created by accelerated depreciation. In other words, rates would be set using a hypothetical tax liability—that payable if straight-line depreciation were used for book and tax purposes alike. In the early years of any specific asset's useful life, ratepayers would pay both the actual current tax bill and the amount which would eventually come due to the Treasury following reversal. These excess revenues would be recorded as deferred tax reserves on the regulated books of account. The cash received by the utility from ratepayers could be used for general purposes, but the values represented by the reserves would be available to the utility to fund future tax liabilities when those liabilities became due.⁶ Again, returning to our example, the revenue requirement of the enterprise under a normalization regulatory regime would be \$220 million, allocated as follows: \$100 million, the return on investment; \$20 million, the return of investment; and \$100 million, the hypothetical tax payment had the enterprise used straight-line depreciation instead of ACRS. Of this \$100 million collected for taxes, \$60 million would be paid in current taxes (Revenue Requirement =

²The standard "gross up" formula is $1-1/\text{MR}$ where MR is the marginal tax rate. In the example, $1-1/.50 \times \$100 \text{ million} = \$200 \text{ million}$.

³Straight-line methods are still approved for tax purposes. Code section 167(b)(1).

⁴Cong. & Admin. News 4048, 4656; Hall and Jorgenson, "Tax Policy and Investment Behavior," *American Economic Review*, LVII (June 1, 1967), pp. 391-414.

⁵"ACRS" stands for Accelerated Cost Recovery System and is codified at Code section 168.

⁶See discussion at note 4, *supra*. See also, Fiekowski, "Accounting for Tax Subsidies with Special Reference to Cost of Service, or 'Fair Rate of Return,' Utility Regulation," Department of the Treasury, OTA Paper 27, May 1979.

Gross income = \$220 million - \$100 million ACRS deductions = \$120 million taxable income). The remaining \$40 million represents deferred taxes and is exactly equal to the assumed tax rate of 50 percent times the difference between the ACRS deduction (\$100 million) and the straight-line deduction (\$20 million).

The 'normalization' school stressed that only temporary timing differences resulted from using accelerated depreciation.

The second, or "flow-through," school argued that the so-called timing differences were permanent for all practical purposes. The tax advantages of accelerated depreciation should, therefore, be immediately passed on to current ratepayers. Returning to our example, the flow-through school argued that the revenue requirement should be set at \$140 million to reflect the enterprise's actual tax expense. To the objection that this "flow-through" method of ratemaking created an intergenerational inequity beginning in year 11 (when rates would increase 71 percent to meet the larger revenue requirement occasioned by the exhaustion of ACRS deductions), it was argued that in the real world plant replacement and inflation would create newer, larger depreciation deductions in the future and that the apparent inequity was in fact an illusion. While reverses would occur with respect to particular assets, on a composite basis depreciation deductions would grow ever larger.⁷

The controversy reached a fever pitch during the mid-1960s. Utilities predictably favored normalization; ratepayers predictably favored flow-through. The arguments were made, and resolved; by the various regulatory commissions. By 1968, those commissions which had taken a position on the dispute had divided approximately down the middle: roughly half required flow-through; roughly the other half approved normalization.⁸

It was then that the utility industry removed the debate to another forum: The House Ways and Means Committee conducting hearings on what was to become the Tax Reform Act of 1969. The industry argued that those regulatory commissions ordering flow-through were perverting the fiscal objective set by Congress in granting the economic stimulus of accelerated depreciation. Investors putting up the capital, not ratepayers, should be the beneficiaries of accelerated depreciation. This could occur only under a normalization regime. Industry repre-

sentatives let slip that the Treasury itself benefited from normalization, in that the larger revenue requirement under normalization produced larger gross income and, thus, in the short run higher actual tax payments (in our example, taxes were \$20 million per year under flow-through and \$60 million annually under normalization).⁹ The industry view prevailed.

The Tax Reform Act of 1969 introduced Code section 167(1).¹⁰ The section was very artfully crafted in that state utility commissions were not required to adopt normalization. Instead, the statute was structured in terms of a penalty exacted against utilities which were the victims of flow-through ratemaking: the privilege to use accelerated depreciation was terminated.¹¹ In other words, the ability to use accelerated depreciation for tax purposes depends upon how the regulatory commission, in its discretion, resolves the flow-through/normalization question. If a commission uses normalization, accelerated depreciation is available. But if it uses flow-through, it has engaged in the supreme act of futility. Once a flow-through rate order is entered, the benefit sought to be flowed through evaporates. It soon became apparent that the only economically rational course available to a regulatory commission was to order normalization. Returning to our example, under either approach the revenue requirement is now \$220 million. Normalization offered the ratepayers the advantage of permitting commissions to treat the \$40 million of deferred taxes as "free" capital on which the investors are not entitled to a return, but in virtually all other respects favored the industry.¹²

The... 'flow-through,' schools argued that the so-called timing differences were permanent for all practical purposes.

Thus, prior to the 1986 Code, the state of affairs in the utility industry was as follows: the tax laws invited regulators to use a normalization method with respect to most categories of public utility property. Those declining the invitation were penalized by being denied the privilege to use accelerated depreciation. The theory underlying normalization was explained at least in part by the Internal Revenue Service and Treasury in terms of maintaining the integrity of the deferred tax reserve so that the reserve was always large enough to fund future tax

⁷For early discussions of both flow-through and normalization, see, e.g., *City of Alton v. Commerce Commission*, 185 N.E.2d 513 (Ill. 1960); *Central Maine Power Co. v. Public Utilities Commission*, 136 A.2d 726 (Me. 1957); *City of Pittsburgh v. Pennsylvania Public Utility Commission*, 128 A.2d 372 (Pa. Super. 1956) (Pittsburgh I).

⁸Twenty states required normalization; 17 required flow-through; 13 had taken no position. *Treatment of Tax Depreciation by House Regulatory Agencies: Hearings on H.R. 8859 before the Comm. on Ways and Means, 91st Cong., 1st Sess. 3907-08.*

⁹See, e.g., (1969) U.S. Code Cong. & Admin. News 1645, 1782-3.

¹⁰All assets of a utility were covered if the utility made an election under Code section 167(i)(4) by June 28, 1970. If the election was not made, regulatory commissions retained some discretion. See, e.g., Code section 167(i)(2)(C).

¹¹See, e.g., Treas. Reg. section 1.167(a)-11(b)(6)(iii).

¹²In other words, in year 2 the enterprise's rate base would be adjusted as follows: \$1 billion - \$20 million (return of investment resulting from the regulatory depreciation allowances in year 1) - \$40 million (reserve for deferred taxes, the amount collected from current ratepayers in excess of actual tax expense for year 1) = \$940 million.

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liabilities which would be incurred after the "reverse." Finally, most utilities had adopted normalization accounting methods and were carrying substantial balances in their deferred tax accounts.¹²

The Problem Addressed by The Tax Reform Act of 1986

The "reserve for deferred taxes" account represents the accumulated projected tax liability which will be incurred by the utility when the reverse occurs and regulatory depreciation exceeds accelerated depreciation. Because no one can know with certainty what the rates will be in the future, the yearly additions to the deferred account have traditionally been computed by using the rate in effect during the year of computation. This method has seemed adequate since there have been historically few changes in corporate marginal tax rates.¹³

What happens when rates change and the balances in the deferred tax account turn out to get overstated or understated? . . .

There is a significant question, however, as to what happens when rates change and the balances in the deferred tax account turn out to be overstated or understated as a result of what proved to be a faulty assumption about future tax rates. The last change in corporate tax rates was two percent when the marginal rates changed from 48 percent to 46 percent.¹⁴ The Service took the position in letter rulings that it was up to the regulatory commissions to decide what to do with the excess balances in the deferred accounts.¹⁵ It concluded that so long as the balance in the deferred account was large enough to fund projected tax liabilities under the new tax rate, the normalization requirements were met. The excess balances could be returned immediately to the ratepayers if the individual commission elected that option.

The corporate rate reduction in the Tax Reform Act of 1986 was 12 percentage points,¹⁶ or a relative decrease of 26 percent.¹⁷ While the reduction caused joy to most corporate tax managers, it was a bitter pill for the utility industry. Over the years, they had collected significant amounts of money from ratepayers using normalization accounting which assumed that the tax rate would be 46

percent when the reverse occurred. The rate reduction meant that the reserves were overstated by a factor of 26 percent. In other words, a utility which has experienced aggregate timing differences of \$100 million under prior law would have collected \$46 million from ratepayers to fund the taxes which would become due when the reverses occurred. Now, with the 34 percent top rate, \$34 million would fully fund the projected tax liabilities. The industry correctly anticipated that it would fall under extreme pressure to return the unneeded portion of the deferred tax reserves, estimated by some to approximate \$20 billion dollars.¹⁸ Because the money already collected to fund future tax collections was not escrowed—the deferred tax reserve did not represent a pool of cash—there was the immediate question of how such repayments would be funded and what effect it would have both on the financial position of the utilities and their access to capital markets.

There also were two other major, collateral problems. Utility operations had presumably been structured upon the assumption that the deferred tax/normalization procedure would continue to generate future cash flows at predictable levels. Because of the reduced Federal tax rate, regulatory commissions would almost certainly reduce current rates to reflect the lower tax expense. As to the current portion of the tax expense, this would produce a "wash" to the utility. But as to the deferred portion of the tax allowance—the cash flow collected fund future tax liability—the utility would suffer.

The industry persuaded Congress to insert section 203(e) into the Tax Reform Act of 1986.

The second issue was whether the utility would be allowed to accrue deferred taxes with respect to assets currently in service if the related deferred tax reserves were already either large enough or close to being large enough to fund projected tax liabilities at the new rates. If these accruals were denied, tax expense cost would decrease, as would rates, further reducing revenues and cash flow.

Faced with the prospect of both reduced cash flow and higher cash demands resulting from regulatory action ordering an immediate return to ratepayers of the excess portion of the deferred tax reserve, the industry persuaded Congress to insert section 203(e) into the Tax Reform Act of 1986.¹⁹ The section, disarmingly short given the signifi-

¹²At the end of 1984, the total of deferred taxes for the electric, gas, and telephone industries exceeded \$37 billion dollars. Rodgers and Foley, "Regulation of Public Utilities under the Tax Reform Act of 1986," National Association of Regulatory Utility Commissioners (January 28, 1987) at p. 4.

¹³The last change was enacted as part P.L. 95-600, which reduced the top corporate rate from 48 percent to 46 percent effective after December 31, 1978.

¹⁴*Id.*

¹⁵See, e.g., Internal Service, National Office Technical Advice Memorandum, Private Letter Ruling 8816001 (June 6, 1985).

¹⁶P.L. 99-514, amending Code section 11.

¹⁷This figure is obtained by dividing the amount of the decrease in marginal rates by the marginal rate in effect prior to the new legislation. 12/48th equals 25.00 percent.

¹⁸See, e.g., Paul, "Utilities Could Face Ratepayer Battle Over \$20 Billion Windfall in Tax Law," *The Wall Street Journal*, October 15, 1986, page 7, col. 1.

¹⁹Section 203(e) of the Tax Reform Act of 1986 provides as follows:

(e) NORMALIZATION REQUIREMENTS.—

(1) IN GENERAL.—A normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of sections 167 or 168 of the Internal Revenue Code of 1986 if the taxpayer,

(Footnote 20)

continued on next page)

cant problem which it addresses, declares that it is a violation of normalization if any rate commission compels a utility to return statutorily defined "excess tax reserves" ("ETR") to the ratepayers faster than they would be returned if a statutory formula called the "average rate assumption method" ("ARAM") is used. In other words, if a utility is to remain eligible to use ACRS, two separate conditions must be satisfied: first, its governing commission must use a normalization method of accounting, compelling ratepayers to fund 34 percent of the difference between ACRS and regulatory depreciation; and second, its commission must treat the ETR in strict accordance with the statutory formula in section 203(e). The ARAM method permits commissions to order the ETR to be returned to ratepayers, but in a glacially slow fashion. The return must be over the remaining regulatory useful lives of the utility's assets, which generally have regulatory lives of 40 or 50 years. Moreover, the return must be rear-end loaded. In other words, the return must be relatively small in the early years and large in the distant future, resembling an accelerated depreciation table read backwards.

Section 203(e) addresses all of the industry concerns previously mentioned. An immediate cash crunch is avoided; the utility is allowed to bolster its revenues with additional collections of taxes, despite their phantom nature; the utility is allowed time to plan for the eventual refund to its ratepayers which potentially could take place many years in the future.

Representative Dorgan's bill threatens to undo the industry's effort and open up for discussion a number of issues which are rather unpleasant from the industry perspective. The remainder of this article will identify some of the major policy considerations in the two significant areas of concern: the return of excess tax reserves already collected and the continued collection of excess taxes.

(Footnote 20 continued.)

in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the excess tax reserve more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method.

(2) DEFINITIONS.—For purposes of this subsection—

(A) EXCESS TAX RESERVE.—The term "excess tax reserve" means the excess of—

(i) the reserve for deferred taxes (as described in sections 167(l)(3)(G)(ii) or 168(e)(3)(B)(ii) of the Internal Revenue Code of 1954 as in effect on the day before the date of the enactment of this Act), over

(B) AVERAGE RATE ASSUMPTION METHOD.—The average rate assumption method is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its regulated books of account which gave rise to the reserve for deferred taxes. Under this method, if timing difference for property taxes reverses, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying—

(i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by

(ii) the amount of the timing difference which reverse during such period.

Existing Excess Tax Reserves

No one seriously questions the fact that the utilities have collected a great deal of money from ratepayers based upon assumptions which are no longer true. The ratepayers can justifiably assert that they have been "overcharged" and that they should get their money back. The utilities can justifiably point to the fact that they do not have the money in cash. They can reasonably claim that they were "surprised" by the change in the tax law and that they should be allowed some breathing space to avoid extreme financial pressures or the disruption of the capital markets that would occur if the industry immediately disgorged its excess reserves. These are political issues, which become tax policy issues only because the tax laws have been historically used to effectuate Congress' long standing policy decision to encourage normalization.

Prior to the enactment of section 203(e), the primary goal of normalization was the maintenance of the integrity of the deferred tax amount.²¹ Violations of the normalization requirement were found to occur when a commission, directly or indirectly, entered a rate order which had the effect of depriving the utility of funds necessary to pay future tax liabilities.

Section 203(e) usurps to the Congress discretion formerly residing in the state commissions.

Section 203(e) represents a significant change in the scope of the normalization concept. The Service had earlier ruled that the state regulatory commissions could deal with excess tax reserves in any manner deemed prudent from a regulatory standpoint. They could be returned immediately to ratepayers, amortized over a five-year period, or amortized over the remaining useful life of the underlying assets. Again, since the excess reserves were no longer needed to provide a fund to pay future taxes, the tax law was a disinterested observer.

Section 203(e) removes this discretion, and creates a single, national mechanism for the return of ETRs. This may be explained only by positing that Congress distrusted the state regulators. Perhaps Congress feared that the commissions would be eager to take the political credit for rate reductions, and would order the immediate flow back of excess tax reserves to the detriment of the financial stability of the entire industry. The legislative history of section 203(e) is devoid of any evidence supporting such intergovernmental suspicion, but the fact remains that section 203(e) usurps to the Congress discretion formerly residing in the state commissions.

The Dorgan bill would simply repeal section 203(e), and return to the state commissions the power to order the disposition of ETRs.

Continued Collection of Excess Taxes

Representative Dorgan's bill is directed toward the question of the return of excess tax reserves. Almost no attention has been given to the question of the continued

²¹See e.g., Fiekowsky, *supra* note 6.

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collection of deferred taxes under Code sections 167(l) and 168. Neither section 203(e) nor H.R. 1049 directly address the problem, yet it could easily involve as many dollars as are associated with existing excess reserves.

Section 203(e) gives specific direction as to what should be done in the case where the reverse has occurred. The section is completely silent, however, as to what procedures are appropriate when the reverse has not yet happened. This omission is critical because the moment of reverse has nothing to do with the question of whether the deferred account contains excess reserves or not. A simple example is the following scenario: the reverse will not occur for another five years. Assume that there is more than enough money in the deferred account to pay projected tax liabilities. Under ARAM, the existing excess reserves cannot even begin to be reduced for five years. During that five-year period, however, the utility may be compelled to add dollars to the deferred tax account to comply with the normalization rules. These additional dollars serve no useful purpose other than to increase the amount of money which will be returned to ratepayers in the future. Yet failure to make these additions may jeopardize the utility's accelerated depreciation election. An existing problem is simply made worse. As a result of the omission, the excess tax reserves which will be amortized after the reverse will consist not only of present reserves, but additional reserves that will be added over the next several years. These current accruals would be financed by the ratepayers and added to the cost of service under the authority of the normalization rules.

An existing problem is simply made worse.

A review of the legislative history of section 203(e) discloses no evidence that this problem was even considered by Congress at the time that the section was enacted. Thus, there is no positive indication that Congress intended to allow the utilities an additional "wind-fall" measured by the collection of excess deferred taxes above and beyond those already accumulated as of the effective date of the Tax Reform Act of 1986. There are a number of policy reasons which support a contrary determination:

1. While the industry may have equities of the type suggested earlier in this article with respect to existing ETAs, no similar claims can be made about continued collections of excess taxes. The burden should be on the industry as to such payments, and the industry has simply made no showing which supports their entitlement to these substantial extra payments funded by the ratepayers.

2. The entire concept of normalization hinges on the integrity of the deferred tax account. This phrase simply means that the values in that account are large enough to fund projected tax liabilities based on current rates. Nothing in normalization doctrine requires the creation or funding of excess reserves above and beyond the amount of those projected liabilities. "Normalization" should not be used as a

boilerplate umbrella to justify and support actions which are unrelated to its precepts.

3. The deferred tax account can be analogized to a cup containing liquid. It makes sense to fill the cup; it does not make sense to fill the cup beyond its capacity. Yet that is exactly what would happen if normalization was used to justify the continued accumulation of deferred taxes. It is unjustifiable to add values to a deferred tax account in the situation where Congress is wrestling with the question of how to amortize excess values already in that account.

4. Equitable principles do not support continued additions to the deferred account. Ratepayers are currently receiving a delayed return of excess values already collected by the utility industry. It would be completely unfair to require ratepayers to bear the further burden of continued additions to the deferred account when it is agreed by all that the account is sufficiently funded for its purpose.

This is an area of obvious major importance which appears to have been overlooked because of the attention given the excess reserves.

Regardless of one's position on that issue, it is difficult to justify the continued accumulations of excess reserves. This issue should not be decided by default or omission and should be presented squarely to Congress so that it can be definitively resolved. Any other approach leads to confusion and the risk of a substantial confrontation between regulators and the industry. That confrontation can only lead to needless problems which can be avoided by facing the issue now.

Summary and Conclusion

For many of the reasons discussed in this article, section 203(e) is not an ideal solution to the problem of excess tax reserves. One can argue with the political choice which underlies its enactment and regardless of one's political position, one can and should be very uncomfortable with the method used by the statute to achieve its goal and the fact that the statute leaves unaddressed a problem of potentially equal or greater magnitude.

It is difficult to justify the continued accumulations of excess reserves.

From the ratepayer's standpoint, Representative Dorgan's bill is a step in the right direction, but it is not a perfect solution either. It merely repeals section 203(e). It does not deal with the accumulation of additional excess tax reserves potentially authorized by Code sections 167 and 168. It seems clear that some effort must be made to identify an alternative solution and to present that solution to the Congress. The need for that effort is made clear not only by the confusing state of the law in this area but because of the compelling political interests and the staggering amount of money involved. This problem should simply not be left to chance resolution.

Mr. McGRATH. If the gentleman would yield.

Mr. DORGAN. Happy to yield.

Mr. McGRATH. I would just point out that the testimony of Mr. Bell and Mr. Huntington regarding electric and gas would probably be true with communications too. In the area of the country that I represent, some of the largest users of the communications system are the industrial users and the banks and stock market types in the New York area in the financial district. And if they were to be given this kind of a fast refund too, already having the ability to conduct their own communications in their own back rooms and across the country, I think the average customer would be adversely impacted.

Mr. DORGAN. Let me ask one further question of this panel, and then we have another panel to call. You have heard me ask other witnesses about the diversification that is going on with utilities. I have mentioned the purchase of 747 airplanes to lease to an airline company, purchase of insurance companies, drug stores and so on. Can you state categorically that no deferred excess taxes have been used as a source of cash for diversification?

Mr. BELL. I can state categorically, Mr. Chairman, that the State regulatory commissions who have appeared here have discretion and complete control over what utilities do in their jurisdictions. Back in 1935, both for the gas companies and for the electric companies, Congress passed the Public Utility Holding Company Act which regulates holding companies, diversification and use of that sort of funds. And the purpose of the holding company act was to cover those areas where the State regulatory commissions did not have direct jurisdiction.

So that certainly for the gas and for the electric companies, that matter is already regulated and it would not seem to be an appropriate policy here.

Mr. HUNTINGTON. We happen to be a regulated public utility holding company as well, and all of our diversified activities take place in separate subsidiaries that are completely insulated by very carefully administered SEC rules from the public utility operations.

With respect to the industry as a whole, you cannot make a categorical statement, because as Commissioner Bradford stated this morning, you cannot trace moneys with total accuracy. But what you can say is that diversified activities of, say a nonholding company utility, can be financed only from retained earnings.

And the excess deferred taxes do not affect utility earnings or the level of retained earnings in any way. The deferred taxes have to be accounted for solely within the utility business as a source of funds for utility plant and equipment. And as such, they have to be returned to ratepayers as dictated by Federal tax law.

So the regulators pay very close attention to how these deferred tax reserves are set up, how they are accounted for, and that they are, in fact, returned to ratepayers.

Mr. DORGAN. I asked the GAO to analyze for me, what is the cash position of the electric and gas industry, and where are they with respect to availability of cash. I have a GAO report that was just issued to me that seems to suggest that electric utilities are in pretty good shape. The need for new plants has abated over the

last few years even though you have some pinching now with respect to supply on the east coast.

If the excess deferred taxes are not used for diversification, and if they are not needed for new plants, why not let the State regulatory commissions make the judgments on a case-by-case basis of when you ought to flow it back to the consumers?

Mr. HUNTINGTON. I would contest your statement that they are not needed for new plant. We did go through a period in the late 1970's and early 1980's when we experienced little or no load growth. That has turned around. In New England, our load has been growing at the rate of—in excess of 5 percent for the last 5 years. And for the Nation as a whole, we are anticipating a load growth of around 2.5 percent looking out into the future.

Now that kind of load growth will certainly demand additional capacity in order to serve our customers with reliable electricity at the lowest possible cost.

And in addition to that new capacity, there are substantial demands on electric utilities to upgrade existing transmission and distribution facilities. So I would certainly say that these funds, these deferred taxes, will certainly be used in the future to invest in new plant and equipment.

Mr. BELL. Certainly the gas companies have constantly changing sources of supply and constant needs to upgrade, too.

Mr. McGRATH. Mr. Chairman, just one question.

Mr. DORGAN. Mr. McGrath.

Mr. McGRATH. Am I to understand from your testimony that the use of these deferred funds is already under the scrutiny of the public service commissions within your jurisdictions? I mean, if you wanted to diversify or use some of these funds for other purposes, it needs to be approved by the—

Mr. BELL. The question of diversification, where you have a holding company, is subject to the Public Utility Holding Company Act. And that is separated and you use separate funding, and you do not commingle the utility operations with the diversification according to very strict standards. Where you have a stand-alone utility company, it is in the complete discretion of the State utility commission, and they are very strict.

Mr. McGRATH. I understand. Thank you.

Mr. DORGAN. The contention is there is no cross-subsidization and that the mechanisms exist by the State regulatory agencies to deal with that; is that correct?

Mr. BELL. Certainly under the holding company act there is none. As you know, cross-subsidization becomes a political issue in California and in other States. And there is now some question of cross-subsidization in California.

But we think, that certainly where you have a holding company and you have separate subsidiaries with completely separate financial statements, and independent finances, independent officers, there is no subsidization.

Mr. KUJAWA. If I may deal with that. We deal with that issue extensively with our clients and the regulatory bodies. And there are very careful Chinese walls built between the regulated utility and a nonregulated operation. So there is a complete and structur-

al separation between the two to eliminate the possibility or any possibility of cross-subsidization.

Mr. DORGAN. Let the record note that the testimony earlier was from the regulatory commissioners that there are very serious problems in this area, and that is something you might want to take a look at.

Let me say that while I might disagree with some conclusions of members of this panel, I respect very much your position. All of us should, in this system of ours, disagree without being disagreeable. I appreciate the statements you have made. You obviously have found a more sympathetic ear with my colleague. We appreciate your willingness to come by and offer these statements, and we will consider them, and we thank you for your testimony today.

Mr. DORGAN. We have one final panel. We would like in the meantime to deal with the second bill very briefly, to hear from Senator Evans. We have already heard very briefly from the Treasury Department. Senator Evans from the State of Washington is with us today, and we will break briefly from H.R. 1049 and hear from Senator Evans on the Indian fishing rights legislation.

Senator Evans, we appreciate your being with us today. We will include your entire statement as a part of the permanent hearing record, and we would be happy to hear a summary from you at this time.

STATEMENT OF HON. DANIEL J. EVANS, A U.S. SENATOR FROM THE STATE OF WASHINGTON, AND VICE CHAIRMAN, SELECT COMMITTEE ON INDIAN AFFAIRS

Senator EVANS. Thank you very much, Mr. Chairman. I will try to be brief and summarize this statement.

I think the issue is clear. We have passed in the Senate a companion piece of legislation which is identical to H.R. 2792, which was introduced into the House. The bill specifically provides that Indian treaties, Executive orders and acts of Congress under which fishing rights are secured shall be construed to prohibit the imposition of a tax on the income of Indians resulting from the exercise of their treaty-secured fishing rights.

Mr. DORGAN. Members of the audience will please take their seats.

Senator EVANS. Mr. Chairman, these rights derive from treaties which were signed in the mid-1850's which have been subject to numerous legal interpretations since; legal interpretations which in the last 20 years have been quite explicit in guaranteeing the rights of Indian tribes to have the opportunity to catch, in the Northwest, at least 50 percent of the fish resource, as well as additional subsistence fishing.

It will not surprise you, I suspect, Mr. Chairman, to learn that the Internal Revenue Service has given a very restrictive reading to Indian treaties. As a result, the IRS has commenced action against certain tribal fishermen of the Lummi, Tulalip, Puyallup, and Swinomish Tribes in the State of Washington. They have done so on the basis that, in essence, the treaties did not expressly or explicitly give exemption from this sort of taxation, therefore it should be taxable. The IRS has ignored the fact the treaties were

signed 75 years before the Federal income tax even came into existence.

We have a division of opinion on this issue between elements of the administration with the Attorney General acting as referee between the lawyers from the Internal Revenue Service, and the Department of the Interior, and others. The Treasury Department, I understand, has testified this morning generally in favor of the legislation, although raising some particular problems they thought the legislation might bring forward; problems they had not discussed with us before.

Mr. Chairman, I think we are faced with one of the fundamental problems involved in construing treaties in light of other Federal laws of general application laws; tension between two applicable and longstanding canons of construction. First, that regardless of the circumstances, exemptions from Federal income taxation be clearly expressed.

And second, that treaties and statutes relating to Indians are to be interpreted liberally in light of the trust responsibility of the United States in bearing in mind the Indians historically inferior bargaining position which characterized the negotiation of their treaties. Unfortunately, the courts have not always been consistent in applying these canons. And the Indians, and particularly these tribal fishermen, tragically are caught in the middle.

Mr. Chairman, I am convinced that this bill does not create a new tax exemption. Instead, it clarifies the relationship between Indian fishermen and the Federal Government which has existed almost without question for over 100 years. We should not sit idly by while the IRS attempts to take away a significant portion of this right.

I have worked for 2 years now with my colleagues from the Senate, Senators Bradley, Inouye, and Adams and the members of the Pacific Northwest congressional delegation to resolve this issue. We even received a letter which I ask be included in the record of this hearing, from the Department of Treasury in which they agree to withhold collection efforts to allow Congress to consider this issue.

However, Mr. Chairman, in spite of our efforts, and in spite of this commitment from the Treasury Department, the Internal Revenue Service continues to harass Indian fishermen. Just 1 week ago today, three members of the Lummi Tribe were tried in U.S. Tax Court for failure to pay income taxes on their treaty-secured fishing income. A number of other tribal members who agreed to Tax Court judgments in September 1987 are receiving computer generated demands for payment.

Mr. Chairman, I think it is time to end the harassment, clarify this situation, and do what is, I believe clearly called for under our treaty responsibilities. We should enact this bill into law, and we should do so as promptly as possible. Hopefully, there might even be an opportunity before we depart for Christmas to see a chance to pass this legislation through the House and join with the Senate in sending it on to the President.

Thank you, Mr. Chairman.

[The statement of Senator Evans follows:]

DANIEL J. EVANS, HAWAII, CHAIRMAN
 DANIEL J. EVANS, WASHINGTON, VICE CHAIRMAN
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United States Senate

SELECT COMMITTEE ON INDIAN AFFAIRS

WASHINGTON, DC 20510-6450

STATEMENT OF SENATOR DANIEL J. EVANS
 HEARING ON H.R. 2792
 SUBCOMMITTEE ON SELECT REVENUE MEASURES
 COMMITTEE ON WAYS AND MEANS
 U.S. HOUSE OF REPRESENTATIVES
 December 14, 1987

Thank you for allowing me to testify today on H.R. 2792. This bill, which is identical to a bill passed earlier this year in the Senate, is one which is needed to clarify the tax exempt status of Indian fishing income. Specifically, the bill provides that Indian treaties, Executive orders, and Acts of Congress under which fishing rights are secured shall be construed to prohibit the imposition of a tax on the income of Indians resulting from the exercise of their treaty-secured fishing rights.

Mr. Chairman, in the decade of the 1850's Washington territorial Governor Isaac I. Stevens negotiated six treaties with Indian tribes in the Pacific Northwest. In these treaties the signatory tribes reserved for their members "the right of taking fish, at all usual and accustomed grounds and stations ... in common with all citizens of the territory ...". Numerous decisions of the Federal courts have established that language in the treaties securing fishing rights do so on and off reservation, free of state regulation, and secure an opportunity to catch up to 50 percent of the harvestable numbers of fish. The Supreme Court has construed the treaties "not as a grant of rights to the Indians, but a grant of rights from them -- a reservation of those not granted."

The fishing rights reserved by the Indians in various treaties and secured by Acts of Congress and executive orders often included not only the right to fish for subsistence purposes but also the right to fish for commercial purposes. At the time several treaties were signed, fish constituted a major part of the Indian diet. Many Indian tribes also used fish for commercial purposes and indeed traded fish in substantial volume. Leaders of Indian tribes are generally thought to have understood that they would be able to continue fishing and trading fish without, in any way, having to turn over to the Federal Government a portion of their catch.

Mr. Chairman, it probably won't surprise you to learn that the Internal Revenue Service has given a very restricted reading to Indian treaties, Executive orders, and statutes which secure Indian fishing rights. In 1982, following its successful prosecution of an Indian employed on a non-Indian fishing boat fishing in non-treaty waters, the Internal Revenue Service began general enforcement efforts against certain tribal fishermen, particularly members of the Lummi, Tulalip, Puyallup and Swinomish tribes in the state of Washington. The Assistant Secretary of the Interior for Indian Affairs promptly requested a legal opinion from the Interior Department Solicitor on the propriety of this effort by the Internal Revenue Service. On September 21, 1983, Solicitor William H. Coldiron transmitted to the Assistant Secretary his opinion. Solicitor Coldiron concluded that "fishermen who are members of tribes that have

established treaty rights are exempt from Federal income tax on fishing income earned pursuant to those treaties."

On November 23, 1985, the Chief Counsel of the Internal Revenue Service issued an opinion disagreeing with the Interior Department Solicitor. According to the Internal Revenue Service Chief Counsel, a tax exemption would not be established unless the language of the treaty or statute "clearly expressed" such a purpose. An exchange of correspondence followed between the Department of the Interior and the Department of Treasury in an unsuccessful attempt to resolve the differences between the two departments. On March 22, 1985, Secretary of the Interior Donald P. Hodel wrote to Attorney General Edwin Meese advising the Attorney General of the interdepartmental dispute and asking for the Department of Justice to resolve it. Secretary Hodel urged the Attorney General to accept the Interior Department position, arguing that

"Diminution of the treaty fishing rights through the imposition of a tax not only represents an attack on the unique relationship existing between the United States and the Stevens treaty tribes, but marks an abrupt departure from President Reagan's January 24, 1983, Indian Policy Statement which reaffirms the Federal Government's commitment to that relationship and to the trust responsibility involving Indian natural resources, and, which further, encourages the development of strong reservation economies."

Nevertheless, on December 12, 1985, the Department of Justice Office of Legal Counsel issued an opinion adopting the view of the Internal Revenue Service. The effect of this decision was to establish the Internal Revenue Service position as the official position of the United States Government and to deny to the courts and to the individual Indian defendants in any subsequent litigation any formal presentation of the views of the Department of the Interior on the issue.

Mr. Chairman, the gist of the IRS position is that a tax exemption must be clearly expressed and that Indian treaties, Executive orders and Acts of Congress which secure Indian fishing rights fail to do so. As many of my colleagues have noted, it is indeed illogical to suggest that Indian treaties should have clearly expressed an exemption from the Federal income tax when the treaties preceded the income tax law by several decades. As if this weren't enough, we are now confronted with the bizarre spectacle of the Administration sending its witnesses to testify in support of this legislation while its tax agents are sent out in an effort to undermine the legislation.

The dispute between the Department of the Interior and the Internal Revenue Service arises out of an inherent tension between two applicable, longstanding canons of construction: first, that, regardless of the circumstances, exemptions from federal income taxation be "clearly expressed"; and second, that treaties and statutes affecting Indians are to be interpreted liberally, in light of the trust responsibility of the United States and bearing in mind the Indians' historically inferior bargaining position, which characterized negotiation of their treaties. Unfortunately, the courts have not been wholly consistent in describing how the balance between these canons of construction should be struck. As a result, the Internal Revenue Service continues to prosecute Indian fishermen for failing to pay a tax that the Interior Department says they don't owe. Tragically, the Indian people are caught in the middle.

Mr. Chairman, this bill does not create a new tax exemption. Instead, it clarifies the relationship between Indian fishermen and the Federal Government which has existed almost without question for over one hundred years. The Indian tribes of the Pacific Northwest reserved for themselves the right to catch up

to fifty percent of the region's commercial salmon and steelhead resource. We should not sit idly by while the Internal Revenue Service attempts to take away a significant portion of this right.

I have worked for over two years now with my colleagues Senators Bradley, Inouye and Adams and the members of the Pacific Northwest congressional delegation to resolve this issue. We have received Administration testimony before the Senate Select Committee on Indian Affairs supporting our legislation. We have even received a letter, which I ask be included in the Record of this hearing, from the Department of the Treasury in which they agree to withhold collection efforts to allow Congress to consider this issue.

In spite of our efforts, and this commitment from the Treasury Department, the Internal Revenue Service continues to harass Indian fishermen. One week ago today, three members of the Lummi tribe were tried in United States Tax Court for failure to pay income taxes on their treaty-secured fishing income. A number of other tribal members, who agreed to Tax Court judgments in September 1987, are receiving computer generated demands for payment. These demands are not in any way individualized, nor is there any awareness on the part of the IRS field staff, until they are informed in writing by the tribe, that these cases should be treated in any way different from those of the ordinary taxpayer.

Mr. Chairman, prompt action is needed by your committee and by the House of Representatives on this important legislation. Last week the world eagerly watched as the President of the United States and the Secretary General of the Soviet Union signed a treaty to limit nuclear arms. Before we make commitments such as this to other countries, however, we should honor those we have made to our native citizens.



ASSISTANT COMMISSIONER
(COLLECTION)

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

The Honorable Daniel J. Evans
United States Senate
Washington, DC 20510

MAY 12 1987

Dear Senator Evans:

This is in response to your letter to the Commissioner dated April 23, 1987, in which you expressed concern about actions taken by Internal Revenue Service employees in connection with the collection of income tax deficiency assessments against Lummi fishermen.

We can assure you that there were no instructions given to our employees to expedite collection of assessments in cases involving fishing income. Also, please be assured that our collection efforts were in no way related to the pending legislation, and were certainly not intended to overcome the effect of that legislation.

However, since S.727 would, if enacted, exempt this type of income from taxation, the Service will withhold collection on any open cases of this kind for a reasonable period of time in order that Congress can consider the bill.

Sincerely,

William M. Wauben
William M. Wauben

Mr. DORGAN. Senator, thank you very much for your testimony. And without objection, we will include in the record the letter that you referenced.

Mr. McGrath.

Mr. McGRATH. I have no questions. Senator, thank you for your testimony.

Senator EVANS. Thank you very much.

Mr. DORGAN. I have one question, Senator. Some have said that this legislation could deny Social Security benefits and Medicare coverage to tribal members. Do you have any observations about that?

Senator EVANS. Mr. Chairman, I think that frankly that is a red herring across the trail of this legislation. This legislation applies to income taxes at State and Federal levels. If this bill does in fact have some impact on the requirement for treaty tribes and their members to pay other taxes and receive other benefits, that is a question that ought to be investigated, to go through necessary hearings and to be resolved by careful reading of the treaties and our current laws.

But I do not believe that passage of this legislation would have anything directly to do with that particular question. And we ought to deal with that separately and when the time comes.

Mr. DORGAN. Mr. Andrews, we have one panel left, the final panel on H.R. 1049. In order to accommodate Senator Evans' schedule, we broke between the third and last panel and heard testimony from Senator Evans on the fishing rights bill. Do you have any questions of the senator?

Mr. ANDREWS. I have no questions.

Mr. DORGAN. All right. Senator Evans, thank you very much for being with us today. We appreciate your testimony.

Senator EVANS. Thank you very much, Mr. Chairman. I appreciate your kindness. And for the panel which will follow me, I appreciate also their willingness to defer for a few moments.

Mr. DORGAN. Thank you.

Next we will call the last panel for H.R. 1049, and the presenters will please come to the table. Mr. Pete Rhinehart, Jr., corporate vice president, AT&T; is Mr. Ernie Liu, vice president of Goldman Sachs with us? John Hulse, vice chairman and chief financial officer of Pacific Telesis Group; James Pendergast, Jr., president, San Marcos Telephone Co.

Mr. Liu from Goldman Sachs is not with us today.

Gentlemen, we appreciate very much your patience and your indulgence. The hearing has been a lengthy one and you all have been present during the entire proceedings. We will be happy to hear your testimony now. We would include your entire testimony as a part of the permanent hearing record. We would ask that you summarize, if possible, in five minutes. We would ask first to hear from Mr. Rhinehart who is corporate vice president for AT&T.

Mr. Rhinehart.

**STATEMENT OF N. (PETE) RHINEHART, JR., CORPORATE VICE
PRESIDENT OF TAX PLANNING AND COMPLIANCE, AMERICAN
TELEPHONE & TELEGRAPH CO.**

Mr. RHINEHART. Thank you, Mr. Chairman. I am Pete Rhinehart and I am the corporate vice president, tax planning and compliance for American Telephone & Telegraph Co. I would like to thank you for the opportunity to present the views of AT&T with regard to H.R. 1049.

AT&T strongly opposes H.R. 1049 because, first, it would defeat congressional intent to stimulate capital investment, and thereby the Nation's economy, by requiring regulated companies to pass excess Federal deferred taxes which have been invested in modern property, plant and equipment to ratepayers before the investment cost has been recovered.

Second, H.R. 1049 would distribute all of the excess Federal deferred tax reserves attributable to accelerated tax depreciation to current ratepayers, thereby causing a rate increase to future ratepayers, creating undue volatility in rates.

Third, the proposal would increase near term capital requirements of utilities, which could be disruptive to both the utilities and the financial marketplace.

Last, H.R. 1049 would put future ratepayers at risk for potential Federal income tax rate increases.

This whole matter is an issue of timing. That is, over what period should the excess tax reserves be passed to ratepayers. No matter what method is used, normalization or flow through, ratepayers will receive the entire benefit of these reserves, which I will refer to as section 203(e) reserves.

Normalization was intended to encourage capital investment, increase productivity and reduce long term costs by providing low cost capital to regulated companies. As a result, Congress did not want the tax benefits of accelerated depreciation flowed through prematurely to ratepayers.

The principal of normalization ensures that the tax benefits resulting from accelerated depreciation are shared with ratepayers and not with shareholders. If normalization were not used, subscriber rates would tend to fluctuate with the level of new investment, thereby hampering effective capital investment planning by regulated companies.

The Tax Reform Act of 1986 reaffirmed congressional intent that normalization should provide capital to encourage investment. Section 203(e) of the act requires that those reserves be normalized over the remaining life of the property. Those reserves are a future liability of the regulated company that will inure to the benefit of ratepayers.

AT&T opposes the proposed bill because normalization provides an equitable method for refunding those reserves to current and future ratepayers. In AT&T's case, this means that about 75 percent of the reserves will be passed to the ratepayers in 7 years, increasing to about 95 percent in 9 years. Thus, the fair treatment of both current and future ratepayers inherent in normalization ensures that the ratepayers who use the property will receive the associated tax benefits over the life of that property.

Normalization of section 203(e) reserves has the effect of keeping rates stable. The resulting stable environment facilitates the ability of the regulated companies to raise capital to maintain and expand current levels of service.

For instance, AT&T will spend approximately \$6 billion in 1988 and 1989 to expand and upgrade its telecommunications network. Meeting major capital needs for improvement and expansion of plant across the telecommunications industry, concurrent with a premature refund of the reserves, would place pressure on the already unstable financial marketplace and could lead to higher interest costs, which would in turn be borne by the customer through higher rates.

Furthermore, by flowing through the section 203(e) reserves, current customers would reap a windfall whose costs would have to be borne by future ratepayers.

For instance, if the entire amount of the reserves were passed through to ratepayers in 1 year, the estimated decrease to AT&T Communications' revenue requirements would be about \$760 million in the year of flowthrough. However, the subsequent year's revenue requirements would increase by about \$1.1 billion. After the volatility of the first 2 years, revenue requirements would remain unchanged, but would remain higher than revenue requirements under normalization.

The inequity to future ratepayers would be further exacerbated if Federal income tax rate increases were increased in the near future. As a result of a tax rate increase, a subscriber rate increase would be required because the deferred tax reserves would then be insufficient to pay the future liability of the regulated company. The subscriber rate increase would be cushioned if normalization of the section 203(e) reserves were maintained.

In summary, normalization provides for a refund of those reserves to current and future ratepayers in an equitable manner, and it holds subscriber rates down while alternative sources of funds are obtained with minimum disruption to regulated companies and the financial marketplace.

Thank you very much for the opportunity to present AT&T's views.

[The statement of Mr. Rhinehart follows:]

STATEMENT OF W. RHINEHART, JR.
CORPORATE VICE PRESIDENT - TAX PLANNING AND COMPLIANCE
AMERICAN TELEPHONE AND TELEGRAPH COMPANY

BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES,
OF THE COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
DECEMBER 14, 1987

Introduction

My name is Pete Rhinehart, and I am the Corporate Vice President - Tax Planning and Compliance for American Telephone and Telegraph Company. I would like to thank you for the opportunity to present the views of AT&T with respect to H.R. 1049, the Utility Ratepayer Refund Act of 1987.

AT&T through its business unit, AT&T Communications, is engaged in the provision of nationwide domestic and international long distance telecommunications services for both voice and data applications. This business is currently regulated by federal and state commissions and is subject to the normalization provisions of the Internal Revenue Code of 1986.

AT&T strongly opposes H.R. 1049 because it would:

- o Defeat Congressional intent to stimulate capital investment by requiring regulated companies to pass excess deferred taxes, which have been invested in new property, plant and equipment, to the ratepayers before the investment cost has been recovered.
- o Distribute all of the excess deferred tax reserve attributable to accelerated tax depreciation to current ratepayers thereby causing a rate increase to future ratepayers, creating undue volatility in rates.
- o Increase near-term capital requirements of utilities, which could be disruptive to both the utilities and financial marketplace.
- o Put future ratepayers at risk for potential tax rate increases.

This whole matter is an issue of timing -- that is, over what period should the excess tax reserves which have been used to purchase new property, plant and equipment, be passed to ratepayers. No matter what method is used, ratepayers ultimately receive the entire benefit of these reserves.

Normalization

To understand H.R. 1049's impact upon the flowthrough of excess tax reserves (hereinafter Sec. 203(e) reserves) attributable to accelerated depreciation, the concept of normalization itself must be understood. Simply stated, normalization requires that -- in establishing customer rates -- the federal income tax reduction attributable to the use of accelerated tax depreciation be equitably distributed over the regulatory life of the asset which generated the reduction.

Normalization of accelerated depreciation by regulated public utilities was first incorporated in the tax law in 1969 and subsequently reaffirmed and expanded by Congress in 1971, 1975, 1981, 1982 and 1986. It was intended to encourage capital investment, increase productivity, and reduce long-term costs, by providing low-cost capital to regulated companies. As a result, Congress did not want the tax benefits of accelerated depreciation flowed through prematurely to ratepayers.

The principle of normalization ensures that the tax benefits resulting from accelerated depreciation are shared with ratepayers -- and not shareholders --

only over the life of the property since the rate base is reduced for tax benefits deferred. Thus, capital is provided to the regulated company for additional investment in property, plant and equipment to improve service, while the cost of capital is reduced, which in turn keeps cost of service lower. This ensures that the regulated company and the ratepayer are given the fairest treatment.

Normalization has been adopted by many public utility commissions as a fair and equitable way to treat other tax benefits, although such treatment is neither statutorily mandated nor otherwise required. For instance, the Federal Communications Commission has applied normalization treatment to the tax benefit of accrued vacation pay. This method provides the regulated company the funds to extend and improve its service, while sharing the tax benefits with both current and future ratepayers.

If normalization of accelerated tax depreciation were not used, subscriber rates would tend to fluctuate with the fluctuation in income tax expense that is caused by changes in the level of new investment. Those fluctuations would hamper effective capital investment planning by regulated companies and would expose the regulated company to the risk that the recovery, through higher rates, of increased capital costs and tax expense may lag behind the incurrence of those costs. Finally, normalization of income tax expense results in low-cost capital and stable cash flow due to stable rates. As a result, the need for external capital is diminished; and the lower cost of capital translates into lower rates for subscribers.

Tax Reform Act of 1986

As stated previously, the Tax Reform Act of 1986 reaffirmed Congressional intent that normalization of tax depreciation should provide capital to encourage investment. Sec. 203(e) reserves do not represent "cash in the bank;" they have been invested in property, plant and equipment, and they are a future liability of the regulated company that will inure to the benefit of ratepayers.

Section 203(e) of the Act requires these reserves to be passed to ratepayers over the remaining life of the property that generated the accelerated depreciation benefit. The formula used to allocate the Sec. 203(e) reserves is known as the average rate assumption method. This method provides an equitable way to reduce the Sec. 203(e) reserves over the remaining regulatory lives of the property. This provision, which applies to all regulated companies under penalty of loss of accelerated depreciation, serves to ensure a uniform approach in all jurisdictions with respect to this item.

The shareholders receive no benefits from the Sec. 203(e) reserves, because the reserves must be excluded from the rate base. In fact, if these Sec. 203(e) reserves were to be flowed through immediately, the rate base of the regulated company would be increased, thus partially mitigating the rate decrease resulting from flowthrough. This increase would occur because the regulated company would be entitled to additional earnings.

H.R. 1049

H.R. 1049 would repeal Section 203(e) of the 1986 Tax Reform Act, which specifies that the average rate assumption method be used for normalizing the Sec. 203(e) reserves and would return jurisdiction to the governing regulatory body. AT&T opposes the proposed bill and supports the normalization provisions in the Tax Reform Act of 1986 for the Sec. 203(e) reserves, because normalization provides an equitable method for a refund to current and future ratepayers. Normalization also allows utility rates to remain stable, while providing for an orderly method to replace funds in the least costly manner; and it provides future ratepayers with service at a low cost.

The benefits of Sec. 203(e) reserves are passed on to current and future ratepayers in full over the life of the asset. In AT&T's case, this means about 75 percent of the Sec. 203(e) reserves will be passed to the ratepayer in seven years, increasing to about 95 percent in nine years. Thus, the fair treatment to both current and future ratepayers inherent in normalization ensures that the ratepayers who use the property will receive the associated tax benefits over the life of that property.

Normalization of the Sec. 203(e) reserves under the average rate assumption method has the effect of keeping rates stable. The resulting stable environment facilitates the ability of the regulated companies to raise capital to maintain and expand current levels of service. Conversely, immediate flowthrough would disrupt this stable environment. For instance, AT&T will spend approximately \$6 billion in 1988 and 1989 to expand the network and upgrade it with new technology to meet consumer demands and provide quality service. Meeting major capital needs for improvement and expansion of plant across the telecommunications industry concurrent with a premature refund of the Sec. 203(e) reserves would place pressure on the already unstable financial marketplace and could lead to higher interest costs, which would in turn be borne by the consumer. In addition, while rates may decline in the first year due to the flowback of the Sec. 203(e) reserves, they may well have to rise in subsequent years to cover any increase in the cost of capital, as those reserves would no longer be available to regulated companies for meeting their capital needs.

Moreover, the passthrough to ratepayers of Sec. 203(e) reserves over a period less than the remaining life of the associated assets -- through a near-term reduction in subscriber rates -- would reduce near-term tax revenues from regulated companies. This treatment would effectively lower income taxes and federal excise taxes for the industry and, accordingly, reduce tax payments to the U.S. Treasury. Further pressure at this time on the revenue side of the federal budget would exacerbate an already large federal deficit.

Furthermore, by flowing through the Sec. 203(e) reserves currently instead of over the assets' remaining regulatory lives, current customers would reap an unintended windfall whose cost would have to be borne (via future rate increases) by future ratepayers. For instance, if the entire amount of the Sec. 203(e) reserves were passed through to ratepayers in one year, the estimated decrease to AT&T Communications' revenue requirement would be approximately \$760 million in the year of flowthrough. However, the subsequent year's revenue requirement would increase by approximately \$1.1 billion. After the volatility of the first two years, revenue requirements would remain unchanged but would remain higher than revenue requirements using the average rate assumption method to pass through the reserves.

The inequity to future ratepayers would be further exacerbated if tax rates were increased in the near future. A rate refund in the current year could be followed by a sharp increase in subscriber rates in future years to recover such a tax rate increase. The subscriber rate increase would be required, because the deferred tax reserves would then be insufficient to pay the future tax liability of the regulated company. If the Sec. 203(e) reserves had been flowed through to reduce subscriber rates, the ability to mitigate a subsequent rise in tax rates without substantially raising subscriber rates would be lost. This risk would be cushioned if normalization of the Sec. 203(e) reserves were maintained, since the required deferred tax would not have been depleted.

Conclusion

In summary, the issue is one of timing, that is, over what period of time should the Sec. 203(e) reserves, which have been used to acquire new property, plant and equipment, be passed through to ratepayers. AT&T opposes the repeal or modification of the normalization provision in Section 203(e) of the Tax Reform Act of 1986 because the method is consistent with the intent of Congress to encourage capital investment by regulated companies. In addition, normalization of the Sec. 203(e) reserves provides for a refund of those reserves to current and future ratepayers in an equitable manner; and it holds subscriber rates down while alternative sources of funds are obtained with minimum disruption to the financial marketplace.

Again, thank you for the opportunity to present AT&T's views.

Mr. DORGAN. Mr. Rhinehart, thank you very much.

Next we will hear from Mr. Hulse, who is vice chairman and chief financial officer of Pacific Telesis Group, and formerly from North Dakota.

**STATEMENT OF JOHN E. HULSE, VICE CHAIRMAN AND CHIEF
FINANCIAL OFFICER, PACIFIC TELESIS GROUP**

Mr. HULSE. Thank you, Mr. Chairman. The testimony that I offer today represents not only the views of my company but those of the local exchange telephone industry as represented by the United States Telephone Association. That membership includes 1,100 local exchange telephone companies across the country, providing employment for over 700,000 people, and investing an estimated \$20 billion each year in the U.S. economy.

I am pleased to have the opportunity to comment on H.R. 1049. Nevertheless, I think it is ironic that I return here after 2 years to discuss again the merits of normalization. In July 1985, I had the privilege of testifying before the House Ways and Means Committee on tax reform. At that time I recommended that normalization of excess deferred taxes for public utilities be included as part of the tax reform package then under consideration.

The provision requiring such treatment was ultimately enacted as section 203(e) of the Tax Reform Act of 1986. By making section 203(e) law, you reaffirmed your belief that normalization is an appropriate Federal tax policy for regulated utilities. H.R. 1049 would repeal section 203, and we urge you to reject that bill.

The year 1986 was a momentous one for American taxpayers. Regulated public utilities were no exception. With its repeal of the investment tax credit, the Tax Reform Act of 1986 substantially raised the cost of capital expansion and sharply curtailed cash flow of regulated public utilities. For example, Pacific Bell, Pacific Telesis' largest subsidiary, expects to lose nearly \$1 billion in cash flow over the next 5 years because of tax reform.

And yet, public utilities will not be permitted to benefit from the act's corporate tax rate reduction. Instead, such benefits will essentially pass directly to utility customers in the form of lower rates. For example, New York Telephone customers are already enjoying lower rates because of their State's public utility commission's implementation of tax reform. And Pacific Bell estimates that its California customers will save nearly \$1.3 billion over the next 5 years as a direct result of the 1986 act, even without repealing 203(e).

In your consideration of H.R. 1049, I hope the subcommittee will not only look back to 1985 but beyond. There is a long legislative history of normalization, and substantial congressional support for normalization as an integral part of Federal tax policy for public utilities.

In 1954, the concept of accelerated depreciation was included in the Internal Revenue Code for the first time because previous depreciation allowances had failed to reflect economic reality, instead serving as disincentive to investment. Your intent was clear, to create a liberalized depreciation policy that would encourage capital formation.

Most recently, you renewed your commitment to efficiency of normalization in connection with the disposition of excess deferred taxes associated with the corporate tax rate reduction contained in the Tax Reform Act of 1986. You have demonstrated your commitment to normalization for nearly two decades now, and utilities have proven that you made a wise choice.

In short, normalization does work. It provides cashflow to utilities for expansion and modernization of the physical plant needed to keep the Nation running, while ensuring that present and future generations of ratepayers receive the full benefit of accelerated depreciation.

Congress reduced the maximum corporate tax rate from 48 to 46 percent in 1979. It did so without including a normalization requirement regarding the disposition of the excess deferred taxes of public utilities. Absent congressional direction, State regulators directed the disposition of the excess deferred taxes. Their respective solutions varied widely and created considerable uncertainty for the utilities and their customers.

Fortunately, no such uncertainty exists with respect to the Tax Reform Act of 1986. Section 203(e) of the act requires that the excess deferred taxes of public utilities be passed to utility customers over the remaining life of the property that generated the accelerated depreciation benefit. It ensures that all public utilities will be treated in a consistent and uniform manner in all jurisdictions with regard to this item.

This approach is fully consistent with the original intent of Congress in making acceleration depreciation available to both regulated and nonregulated taxpayers.

I should emphasize that contrary to assertions of proponents of H.R. 1049, public utility shareholders do not keep any of the benefits of excess deferred taxes. Far from being a windfall for utilities or their shareholders, section 203(e) is a windfall for consumers and unregulated corporations. The consumers enjoy lower rates as a result of receiving the utilities' excess deferred taxes.

For unregulated corporations, they too enjoy reduced utility rates. Most importantly, they have no similar requirement to direct the disposition of their excess deferred taxes. In fact, a recent exposure draft released by the Financial Accounting Standards Board will allow them to take their excess deferred taxes into income, artificially boosting profits.

That aside, section 203(e) was enacted after consideration by a House task force on capital formation issues. Both Houses of Congress adopted the language of the section as originally stated in H.R. 3838.

The key to the entire issue is who should dictate ratemaking treatment for federal tax benefits. Normalization implements congressional intent, as has been stated from the outset. And proponents for the bill you consider today assert that the excess deferred taxes that are the subject of normalization belong to the consumer. That is simply wrong. We know that these monies are savings from Federal taxes. They are Congress' domain.

We also know that Congress has designated treatment of these monies as a win/win situation. The consumer, utilities, and the

goal of national economic growth are all well served by the normalization principles of section 203(e).

The impact of a change in section 203(e) of the Tax Reform Act of 1986 is more than theoretical. When the return of the excess deferred taxes under section 203(e) is compared with various scenarios of flowthrough under H.R. 1049, it becomes clear that H.R. 1049, not section 203(e), is anticonsumer.

For example, we have studied a variety of scenarios of possible flowthrough under H.R. 1049. In every case, using Pacific Bell's actual intra-state excess tax reserve, ratepayers end up paying sustained higher rates under accelerated flowthrough scenarios than under section 203(e). So, while there would be a short-term benefit to ratepayers of rapid flowthrough, there will be a long-term detriment to utilities' customers if H.R. 1049 becomes law.

The effect on utilities of a change in current law would be to drive them prematurely to the capital markets to replace the financing for plant and equipment that has been provided by the cash-flows generated by excess deferred taxes. Contrary to the arguments advanced by some proponents of H.R. 1049, utilities do not have their excess deferred taxes available as ready cash. These amounts have already been invested in plant and equipment.

In addition, resorting to the capital markets for the utilities could drive up the cost of debt and/or equity, resulting in still higher long-term rates for utility customers. Moreover, such a large amount of financing necessary to replace lost capital could force bond raters to downgrade utility debt ratings, also driving up the cost of debt.

In summary, Congress has provided the tax benefits associated with accelerated depreciation in order to encourage utility capital formation. As a result, utilities have been better able to provide their customers with the most efficient service with modern equipment while keeping long-term utility rates down. Section 203(e) is merely a logical extension of this sound Federal tax policy.

Therefore, I urge you to not undo what you have already done so well. The tax system you fashioned works. To paraphrase an old adage, if it isn't broke, don't fix it. Thank you.

[The statement of Mr. Hulse follows:]

Testimony of John E. Hulse

Vice Chairman and Chief Financial Officer

Pacific Telesis Group

Mr. Chairman, Members of the Committee, my name is John E. Hulse, Vice Chairman and Chief Financial Officer, Pacific Telesis Group, a diversified telecommunications company headquartered in San Francisco, California. I am here on behalf of both Pacific Telesis Group and the United States Telephone Association (USTA) which represents more than 1,100 local exchange telephone companies throughout the country, providing employment to over 700,000 people and investing approximately \$20 billion annually in the U.S. economy.

I am pleased to have the opportunity to comment on H.R. 1049, the "Utility Ratepayer Refund Act," legislation to repeal Section 203 (e) of the Tax Reform Act of 1986 (TRA '86).

I think it is ironic that I return here, after two years, to discuss again the merits of normalization. On July 25, 1985, I testified before the House Committee on Ways and Means recommending that normalization of excess deferred taxes for utilities be included as part of the Tax Reform package then under consideration. As you know, Section 203 (e) of TRA '86 requires such treatment. I appear before you today to urge this Committee to stand by its commitment to normalization as appropriate tax policy, and reject H.R. 1049.

The Tax Reform Act of 1986

The year 1986 was a momentous one for American taxpayers. Regulated public utilities were no exception. With its repeal of the investment tax credit, TRA '86 substantially raised the cost of capital expansion and sharply curtailed cash flow of regulated telephone companies. For example, Pacific Bell, the largest subsidiary of Pacific Telesis, expects to lose nearly a billion dollars in cash flow over the next five years because of Tax Reform.

At the same time, public utilities are not permitted to benefit from the Act's corporate tax rate reduction from 46% to 34% which will essentially pass directly to utility customers in the regulatory process. Some State public utility commissions are further along in implementing Tax Reform than others. Some, such as New York, have even finalized tariffs taking into consideration Tax Reform, including Section 203 (e). New York telephone customers will enjoy substantially lower rates because of their commission's implementation of Tax Reform. Pacific Bell estimates that its California customers will save nearly \$1.3 billion over the next five years as a direct result of TRA '86 -- without repealing Section 203 (e).

In addition, new uniform capitalization rules and other provisions eliminate large current tax deductions and spread them out over a period of years. The long-range effect of TRA '86 is to increase the need for external financing by local exchange carriers. Passage of H.R. 1049 would greatly aggravate this difficult situation.

Section 203 (e)

Section 203 (e) of TRA '86 requires excess deferred tax amounts to be passed on to subscribers over the remaining life of the property that generated the accelerated depreciation benefit. It ensures that all public utilities will be treated in a consistent and uniform manner with regard to this item. This approach is fully consistent with the intent of the original accelerated depreciation legislation, previous normalization legislation and fiscal policies relating to TRA '86. Public utility shareholders are by no means allowed to keep any of the benefits of the excess deferred taxes. In the nonregulated sector, these benefits enure directly and permanently to the shareholders.

H.R. 1049: Unwise Legislation

USTA and its member companies strongly oppose H.R. 1049 because it would:

Permit an inequitable distribution of the tax benefits from accelerated depreciation to current subscribers to the detriment of future subscribers.

Undermine the ability of local exchange carriers to raise capital for essential telephone plant replacement and innovation.

Destablize the overall financial structure of individual companies in our industry.

Frustrate Congressional intent for stability and consistency in the promulgation and application of our tax laws.

Disrupt the overall regulatory environment under which telephone rates are set.

Normalization of excess deferred taxes, as required by Section 203 (e) of TRA '86, provides a benefit to the local exchange telephone industry, its customers and the U.S. Government. Any attempt to reverse the legislative action that created this provision should be rejected.

LEGISLATIVE HISTORY OF NORMALIZATION

In considering H.R. 1049, I hope this Committee will not only look back to 1985, but will take into account the long history of acceptance of normalization as an integral component of tax policy for regulated utilities.

Accelerated Depreciation

Accelerated depreciation was included in the Internal Revenue Code of 1954 because previous depreciation allowances failed to adequately reflect economic reality and actually acted as a disincentive to investment. This Committee's report on the legislation explained:

For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production and a higher standard of living. H. Rpt. 83-1337, 83rd Cong., 1st Sess. (1954), p. 24.

(Because of the capital formation incentives contained in the Internal Revenue Code, Pacific Bell has been able to provide the telecommunications network necessary for California's economy to grow and flourish. In recent years, approximately 25% of the Company's multi-billion dollar capital investment program was funded by cash flow generated by accelerated depreciation and the investment tax credit.

These internally-generated funds have been critical to Pacific Bell's ability to meet the telecommunications needs of 22 million people in California. Had this source of funding not been available, the cost of raising capital in external financial markets would have most assuredly driven up the cost of local telephone service in the State and impaired our ability to compete with nonregulated telecommunications providers).

Ratemaking Controversy

Following enactment of the 1954 Code, many utilities began to use accelerated depreciation. Because the use of accelerated depreciation reduced the utilities' Federal income tax expense, many State regulators ordered the utilities to immediately "flow-through" (i.e., pass on) these tax benefits to ratepayers in the form of reduced rates. By the late 1960's, some regulatory agencies took an even more aggressive approach -- going so far as to flow-through the tax benefits of accelerated depreciation to ratepayers where, in fact, the public utilities had not elected to use accelerated depreciation.

However applied, the regulatory intent of flow-through was the same: to lower customer rates over the short term to reflect a reduction in the cost of service attributable to the lower Federal income tax expense associated with the use of accelerated

depreciation. H. Rpt. 91-413, 91st Cong., 1st Sess. (1969), pp. 131-136. Lower customer rates meant lower revenues for utilities which, in turn, lowered their income tax expense even further, lowering Federal tax revenues.

In time, Congress became concerned over the potential for large tax revenue losses to the U.S. Treasury resulting from expanded use of flow-through of accelerated depreciation for ratemaking purposes. It was estimated that regulatory flow-throughs of accelerated depreciation could more than double the Federal Government's revenue losses attributable to the use of accelerated depreciation for tax purposes. H. Rpt. 91-413, *supra*, 132.

Congress was also troubled that flow-through could weaken the competitive position of regulated utilities, both in terms of the pricing of their products or services and also the attractiveness to equity investors. S. Rpt. 91-552, 91st Cong., 1st Sess. (1969) p. 172.

Normalization Introduced

Acting in response to both the perceived threat to Federal tax receipts and the potential undermining of economic competitiveness of public utilities, Congress enacted the first normalization provisions as part of the Tax Reform Act of 1969.

Although complex in application, the reason for requiring normalization was simple enough: to limit the practice of flow-through of accelerated depreciation to those utilities which had already been put on a flow-through basis by regulatory agencies. All other utilities were required either to normalize or to be restricted to using the same method of depreciation for both tax and ratemaking purposes. Use of any ratemaking treatment contrary to the rules established in the 1969 Act would cause the utility to lose its eligibility to use accelerated depreciation on its Federal income tax return.

As defined in the Act, normalization requires that regulators use book depreciation in calculating a utility's tax expense for ratemaking purposes, but allows accelerated depreciation in calculating the utility's actual tax payments. Since book depreciation is generally slower than tax depreciation, during the early years of an asset's life ratemaking tax expense is greater than actual tax payments. The difference is required to be accounted for in a reserve for deferred taxes, and is made available to the utility for capital investment. The amount of the deferred tax reserve is either subtracted from the utility's rate base or treated as zero-cost capital. In either case, the utility is not permitted to earn a return on amounts represented by its deferred tax reserve.

In 1981, Congress reaffirmed its support of normalization when, as part of the Economic Recovery Tax Act of 1981, it mandated normalization for all public utility property placed in service under the Accelerated Cost Recovery System.

Most recently, the Congress explicitly acknowledged the soundness of the policy of normalization in connection with the disposition of excess deferred taxes arising from the corporate tax rate reduction enacted in TRA '86.

Origins of Section 203 (e)

I would like to describe in some detail the history of Section 203 (e) of TRA '86 because this is the provision which H.R. 1049 seeks to repeal, and particularly because it has been alleged that the provision was "slipped" 1/ into the bill "without debate" 2/ to quote the author of the legislation, Mr. Dorgan. 1/ April 1987 letter from Cong. Dorgan to "Consumer Leader"; 2/ Congressional Record, April 3, 1987, p. H1774.

When Congress reduced the corporate tax rate from 48% to 46% in 1979, there was no normalization requirement included in the law regarding the disposition of excess deferred taxes of public utilities. As a result, State regulatory bodies varied widely in

their treatment -- ranging from no action, to immediate flow-through, to normalization. Fortunately, the amounts at stake were small, so utilities and ratepayers alike were not egregiously harmed by this lack of guidance from Congress.

When the President submitted to the Congress his Tax Reform proposal, it contained a provision requiring that excess deferred taxes of all corporate taxpayers continue to be paid to the U.S. Treasury. "The President's Tax Proposals for Fairness, Growth and Simplicity", May 29, 1985, Chapter 7.07, pgs. 192-196. The so-called "Windfall Depreciation Recapture" tax was widely denounced by Members of Congress and corporations, and was subsequently omitted from all Tax Reform packages considered by Congress.

Congressional Deliberations

Following publication of the President's Tax Reform proposal, I testified before this Committee during its hearings on Tax Reform. With regard to normalization of excess deferred taxes, I stated:

In addition, and very importantly, the new tax statutes should specify that the difference in the deferred tax reserves of public utilities which results from the reduction of the corporate tax rate be normalized over the remaining lives the related assets. Testimony of John E. Hulse, Vice Chairman and Chief Financial Officer, Pacific Telesis Group, before the Committee on Ways and Means, U.S. House of Representatives, July 25, 1985, p. 17.

When the Joint Committee on Taxation prepared its "Tax Reform Proposals in Connection with Committee on Ways and Means Mark-up," the report contained only a general reference that normalization of depreciation benefits for public utility property be continued as under present law. JCS 44-85, September 26, 1985, p. 16. After numerous discussions with and among Members and staff (including, I might add with the author of the pending legislation), recognition was given to the omission of specific guidance with respect to disposition of utility excess deferred taxes.

On November 18, 1985, a Task Force of Members on this Committee was assigned to deliberate on capital formation issues. The Members assigned to the Task Force were: Mr. Gephardt (as Chairman) and Messrs. Pease, Matsui, Coyne, Archer, and Schulze. On November 19, 1985, the Task Force presented in writing its recommended changes to the mark-up document. One of the items appearing on the list of sixteen recommended changes was:

14. Providing normalization of excess deferred taxes of regulated utilities due to tax rate reduction.

The Task Force recommendations were subsequently considered and agreed to by the Membership of the full Committee. Since the mark-up was closed to the public, only the Members present could describe the debate. One thing is clear, however, and that is that the issue was raised publicly, and opportunity for debate was available.

This Committee having agreed to the provision, Section 203 (e) was included in the reported version of H.R. 3838, and was not altered in the Senate, or in conference.

NORMALIZATION AS FEDERAL TAX POLICY

Having described the legislative history of normalization, and in particular normalization of excess deferred taxes, I would like to address its appropriateness as a Federal tax policy issue.

The question of who should dictate the ratemaking treatment of Federal tax benefits depends in large part on the intended purpose of the benefit. Normalization is an accounting mechanism designed to implement for public utilities the intended purpose of Federal tax statutes as they apply to other corporations. In the case of accelerated depreciation, the Congress clearly intended that the tax

benefits be used as a stimulus to capital investment. If Congress had intended that utilities reduce their consumer rates, it would have granted a tax rate reduction instead of providing a tax incentive. Absent a requirement for utility normalization, the Federal tax benefit of accelerated depreciation might be used by State regulators to subsidize utility rates, not encourage capital formation.

Since the benefit of tax deferrals represents an investment of Federal tax dollars, directing the disposition of those benefits is entirely appropriate as a function of Federal tax policy. Since 1969, Congress has time and time again endorsed the principle of normalization. In each instance, Congress has recognized the importance of normalization in ensuring the availability of the tax law's capital formation incentives to public utilities and, in fact, has expanded its scope to guarantee proper treatment of Federal tax benefits by State regulators.

Normalization allows a regulated company to extend and improve the quality of its service while passing along tax benefits to both present and future subscribers. Without normalization, future subscribers are charged for the depreciation of assets, but receive no offsetting tax benefits.

With respect to the disposition of utility excess deferred taxes, proponents of H.R. 1049 have asserted that the dollars involved belong to consumers. This is simply wrong. The dollars involved are Federal tax revenue, a deferral of which was granted utilities through accelerated depreciation to accomplish the goals of Congressionally established capital formation tax policy. Ratepayers have received the benefits of accelerated depreciation in direct proportion to the level of depreciation expense they supported.

Because of TRA '86's reduction of the maximum corporate tax rate, a portion of the taxes that had been deferred in prior years will not be paid to the Federal government in the form of corporate income taxes. Since these taxes were deferred under Congressional directive, the taxes that become excess deferrals when the rate is reduced are revenues whose disposition is rightfully reserved to Congress. Section 203 (e) of TRA '86 faithfully carries out Congressional intent in determining the disposition of these revenues.

It is worth noting that Congress could just as easily have decided that the excess deferred taxes reflected on the public utilities' books of account should continue to be paid to the Federal government, as was proposed by the President in his Tax Reform proposal. Instead, Congress determined that the excess deferred taxes of utilities should continue to perform their original function as temporary support for utility capital investments, but that such amounts should be paid to ratepayers (rather than the Federal Government) according to the timetable originally envisioned prior to the rate change. So, it is true that ratepayers will receive the benefit of utility excess deferred taxes, but it is only through Congressional direction, both as to designation and to timing, that the revenues in question will be made available to ratepayers. Stated another way, the revenues in question are Federal revenues until they are actually paid to ratepayers.

So if H.R. 1049 is a bill whose only purpose is to transfer jurisdiction over the disposition of excess deferred taxes to the States from the Congress, the bill is an inappropriate delegation of Congressional authority, and is inconsistent with long-standing Federal tax policy.

ECONOMICS OF NORMALIZATION

To understand normalization, one must understand how regulation treats a utility's investments in property used to provide utility services. A utility recovers its costs and earns a reasonable rate of return on its investments by charging ratepayers for the current-year cost of its plant and equipment used to provide utility

services, and by charging ratepayers for the cost of debt and equity necessary to finance the costs of plant and equipment not yet recovered through rates.

The allowable cost recovery for the use of plant and equipment in providing utility services is the depreciation allowance for that year. These assets are classified according to use, and each is accorded a depreciable life and method in order to establish the proper charge to ratepayers. Most regulators require straight line depreciation, and establish a book (or regulatory) life for each asset that is intended to reflect the economically useful life of that asset. Ratepayers are charged for the depreciation expense of an asset ratably over the book life of the asset. This proration treats all generations of ratepayers equitably because they are charged for depreciation expense of each asset over the same period that the asset is providing service to them.

The amount of utility investment that has not been recovered from ratepayers previously through depreciation expense is the utility's rate base. The utility's rate base is investment that is not currently supported by ratepayer charges (i.e., depreciation expense); it is supported by debt and equity. The carrying charges for this debt and equity are paid by ratepayers and represent the utility's return on its investment. The cost of debt is a matter of market conditions and an evaluation by bond raters of the risk posed by lending to the particular utility. The equity charge is determined by the regulators as an adequate return to shareowners.

Factoring in income tax expense and tax depreciation makes these charges more complicated. Tax depreciation is generally faster than book depreciation in both life and method. The question presented here is how to treat the difference between tax and book depreciation. Absent normalization, regulatory commissions might treat tax depreciation as a simple reduction in income tax expense, and flow-through the benefit of accelerated tax depreciation to ratepayers immediately. The effect of this flow-through would be to reduce utility tax expense in the early years of an asset's life, and increase tax expense in the latter years of the asset's life. The benefit of accelerated tax depreciation would, then, go directly to ratepayers in the form of a utility rate subsidy in the early years of an asset's life.

However, Congress did not intend that the tax benefit of accelerated depreciation be used as an artificial utility rate subsidy. As mentioned earlier, Congress intended that the tax benefit be used to stimulate capital formation. Normalization was devised as an accounting mechanism designed to offer utilities the same incentives for capital formation as are accorded other corporations. As a stimulus for capital formation for public utilities, normalization allows utilities to use the timing difference between book and tax depreciation as a source of funding for capital improvements. The funding source is taxes whose payment to the Federal government has been deferred. Normalization treats these taxes as an interest free loan from the Federal government to the utility. (Note that the loan is not from ratepayers; it is from the Federal Government as a result of Federally-mandated tax policy). The life of the loan is the same as the book life of the property that generated the tax benefit, with principal (deferred taxes) being paid pro rata when the timing difference between book and tax depreciation reverses.

Normalization requires that a utility reduce its rate base by the amount of its deferred taxes to reflect the fact that a portion of the rate base is funded by this cost-free capital. The utility is prohibited from recovering from ratepayers any return on investments equaling in value its deferred tax reserve. To suggest, as Mr. Dorgan has, that utilities are using deferred taxes to support unregulated activities is to ignore the fact that ratepayers are being relieved of having to pay carrying charges on investments in regulated activities supported by deferred taxes. Indeed, the allegation simply misrepresents the truth.

Consumer Benefits of Normalization

The principal benefit of normalization to ratepayers is to lower the overall cost of capital on investments in property used to provide

regulated services. Normalization provides substantial benefits to ratepayers because it keeps utility rates lower than they otherwise would be. Utilities benefit from the increase in cash flow that results from the deferral of taxes and the related mitigation of the need to obtain additional external financing (i.e., additional debt and/or equity). Note that the utilities' shareowners derive no direct benefit from normalization of accelerated depreciation.

Another consumer benefit of normalization is the effect of matching tax benefits with property costs. By spreading the tax benefits over the life of the related property, the same ratepayers that are enjoying the service provided by the utility property (and supporting its cost) are also enjoying a *pro rata* share of the associated tax benefits. This matching effect is not only consistent in theory, it ensures that utility rates do not experience dramatic swings that would result in sustained higher rates. Predictable utility rates is one of the important benefits that ratepayers enjoy in a changing economic environment.

An Overview of Section 203(e)

With respect to excess deferred taxes, all of the above attributes of normalization generally apply equally well to normalization of excess deferred taxes. Contrary to assertions of supporters of H.R. 1049, normalization of excess deferred taxes is no different theoretically or actually than normalization of accelerated tax depreciation, for example.

Excess deferred taxes represent the tax benefit of prior tax depreciation deductions, taken at the then statutory tax rate, which are deferred to the benefit of ratepayers and utilities. The excess exists as a result of the effect that the corporate tax rate reduction has on prior tax depreciation. Amounts deferred at the higher tax rate in anticipation of being paid to the Federal Government at that higher rate are greater than the taxes that will actually be paid at the lower tax rate.

The appropriateness of applying normalization principles to excess deferred taxes stems from the original purpose of the deferred taxes now found to be in excess. The tax deferrals from accelerated depreciation were intended to provide utilities with a source of investment capital, while also ensuring that ratepayers enjoy the full benefit of accelerated depreciation over the useful life of the related property. Absent normalization, the reduction in corporate tax rates would retroactively rescind the promise of investment capital for utilities, and stable rates that match costs and benefits for ratepayers. Stated another way, normalization of excess deferred taxes simply ensures that ratepayers will enjoy the full benefit of prior tax depreciation deductions under the schedule in effect when the underlying plant and equipment were placed in service.

Average Rate Assumption Method

Section 203 (e) of TRA '86 specifies that the excess deferred taxes of public utilities should be amortized no more rapidly than over the remaining book lives of the assets that generated the excess. P.L. 99-514, 99th Cong., 2nd Sess. (1986).

Specifically, the new tax law provides that the reduction in the deferred tax reserve should be flowed-through to ratepayers over the remaining book lives of the assets that generated the initial deferral of taxes using the "average rate assumption" method. TRA '86, Sec. 203 (e) (1).

The Average Rate Assumption Method applies to the reversal of book/tax timing differences. The amount of deferred tax adjustment is determined by taking the ratio of the aggregate deferred taxes for that asset vintage account to the aggregate timing differences for that asset vintage account at the beginning of the taxable year and multiplying that ratio by the amount of the reverse timing differences occurring for the asset vintage account during the taxable year. TRA '86, Sec. 203 (e) (2) (B).

The Average Rate Assumption Method assures that no extraordinary

adjustment will be required when there is a change in the corporate tax rate because the deferred taxes will be fully amortized using a weighted average of all tax rates that were used in building the reserves. By the time the deferred tax reserve is fully amortized, no surplus will remain. H. Rpt. 99-426, 99th Cong., 1st Sess. (1985), p. 149; S. Rpt. 99-313, 99th Cong., 2nd Sess. (1986), p. 98. The excess will have been reflected in the regulated books of account as a reduction to the regulated utility's tax expense over the book lives of the associated assets.

The Average Rate Assumption Method is consistent with the expectations of both utilities and their customers, and is particularly important because utilities have invested in plant and equipment relying on the cash flow provided by the deferred tax reserve. To flow-through excess deferred taxes to customers at a faster rate would seriously disrupt utility rate stability and result in higher rates in the long term for utility customers.

Section 203 (e) of TRA '86 differs in its purpose from the President's "Windfall Depreciation Recapture" tax in only two respects: it applies only to regulated utilities (instead of corporations), and it allows ratepayers (instead of the Federal Government) to receive the excess deferred taxes.

Far from being a windfall for utilities, Section 203 (e) is a windfall for consumers and unregulated corporations. It's a windfall for consumers, as I will show later in my testimony, because they will enjoy lower rates as a result of receiving the benefits of a utility's excess deferred taxes, instead of having the Federal Government collect the taxes. It is a windfall for unregulated corporations, not only because they too will enjoy reduced utility rates, but most importantly because they have no similar requirement to direct the disposition of their excess deferred taxes. In fact, a recent Exposure Draft released by the Financial Accounting Standards Board proposes to allow unregulated companies to immediately take their excess deferred taxes into income, artificially boosting profits. That is why I am baffled by the coalition of corporations (including General Motors, Bethlehem Steel, Dow Chemical, du Pont and others) that is supporting H.R. 1049. They not only will pocket their own excess deferred taxes, they also want utilities' excess deferred taxes. Equity would demand that unregulated corporations be treated no differently than utilities with regard to the disposition of their excess deferred taxes. They shouldn't be allowed to have it both ways.

Effects of Repealing Section 203 (e)

The impact of a change in Section 203 (e) of TRA '86 is more than theoretical. The following table compares the effect on Pacific Bell's short and long-term revenue requirement of flow-through of excess deferred taxes under the Average Rate Assumption Method versus H.R. 1049. The calculations are based on Pacific Bell's actual intrastate excess deferred taxes of approximately \$600 million. For comparative purposes, the flow-through of excess deferred taxes is assumed to occur at a straight line rate over a period of either one, three, five, or ten years.

(\$ Millions) Cumulative Benefit * Period	H.R. 1049 Flow-through Period			
	1 Year	3 Years	5 Years	10 Years
1 Year	(\$780)	(\$140)	(\$20)	\$80
5 Years	(70)	(190)	(310)	40
10 Years	310	190	60	(250)
15 Years	520	400	280	(30)
Full Asset Lives	610	490	360	50

* Cumulative intrastate revenue requirement benefit or (detriment) of Average Rate Assumption Method versus H.R. 1049 over various periods of time.

As can be seen from examining the "1 Year" column in the above table, immediate flow-through of the excess deferred taxes in year 1 produces a \$780 million benefit to the customer. However, within five years the cumulative benefit has declined

to only \$70 million and, by year 15, the Average Rate Assumption Method produces a cumulative benefit of \$520 million. This table illustrates the major flaw of premature flow-through of excess deferred taxes: namely, the sacrifice of substantial long-term benefit for a one-time short-term reduction in rates. This relationship is also true, but to a lesser degree, if the excess deferred taxes are flowed-through over three or five years.

The effect on utilities of a change in current law would be to drive them to the capital markets to replace the financing for utility plant and equipment that had been provided by excess deferred taxes. As noted earlier, the subtraction from rate base of the value of deferred taxes means that alternative financing will be required to support this investment, should excess deferred taxes be prematurely flowed-through to ratepayers. In addition to the implications for ratepayers noted above, a rush to the capital markets by utilities could drive up the cost of debt and/or equity and result in still higher long term rates. Moreover, such a large amount of financing necessary to replace lost capital could force bond raters to downgrade utility debt ratings, also driving up the cost of debt.

For those who are unconcerned with the vicissitudes of the financial marketplace, there are other possible ramifications. Should a utility experience difficulty in obtaining external financing, an alternative would be to reduce expenses. Such an eventuality could lead to a loss of jobs or a reduction in maintenance or modernization of plant and equipment.

An Alternative to H.R. 1049

The foregoing is true, not only for the scenarios presented in our table, but also for the proposal offered by Mr. Dorgan during the Democratic caucus meeting on the Fiscal Year 1988 Budget Reconciliation this fall. I would like to state for the record that this proposal also strikes at the heart of normalization policy and would not only subvert the intent of Section 203 (e) of TRA '86, but would undermine the long-standing Congressional commitment to the principle of normalization (as embodied in Sections 167 (1) and 168 (i) (9) of the Internal Revenue Code) by unreasonably limiting future accruals to a utility's deferred tax reserve.

The alternative is simply another way to achieve the goal of H.R. 1049, namely, to accelerate the flow-through of excess deferred taxes with adverse consequences to ratepayers and utilities similar to those shown in the flow-through scenarios I have discussed perviously. In effect, the proposal penalizes a utility for making investment decisions based on the value of previous tax deductions, by limiting the benefit of future deductions. The effect on ratepayers is to permit a short term reduction in utility rates, followed by sustained long term higher rates. These long-term rates more than offset the benefit of the short term rate reduction. The alternative to H.R. 1049 would violate the fundamental premise of normalization that tax benefits should be matched with associated utility costs.

Impact of Section 203 (e)'s repeal on Future Changes in Tax Rates

In view of economic pressures to close the budget deficit gap, as well as other political pressures, it is not inconceivable to imagine the tax rate rising in the future. Normalization would set the stage for resolving this situation in an orderly and equitable manner. Premature flow-through, in this instance, would create an immediate liability for the then current subscriber -- an obviously disruptive result. In a world of constant business and tax changes the normalization approach smooths out the distribution of benefits and costs and fosters a more stable regulatory environment.

CONCLUSION

Normalization of the tax benefits of accelerated depreciation has worked well for the public utility industry for nearly two decades. It is an equitable and sensible way to pass tax benefits to subscribers while at the same time providing stability in the regulatory process. Enactment of H.R. 1049 would create uncertainty for regulated utilities and would destabilize the financial underpinnings of one of the most important sectors of our economy.

H.R. 1049 is bad policy for a number of reasons.

First, it delegates to the States responsibility for determining the use and disposition of Congressionally authorized tax benefits, contrary to long standing Federal tax policy.

Second, it provides no consumer benefit -- unless it benefits consumers to get short term rate reductions at the expense of sustained higher rates that more than offset the earlier reductions.

Third, it will send utilities to the financial markets for major infusions of capital, at a time when the markets are unstable, to say the very least. All of the costs of these borrowings will be paid by ratepayers.

Finally, it would further benefit large unregulated corporations that are already under no restraint to determine the disposition of their excess tax reserves, at the expense of utilities and their ratepayers.

H.R. 1049 should be rejected. The issue was appropriately and openly dealt with in 1986 and nothing has changed to warrant passage of this legislation.

Mr. DORGAN. Mr. Hulse, thank you very much.
Mr. Pendergast.

STATEMENT OF JAMES J. PENDERGAST, PRESIDENT, SAN MARCOS TELEPHONE CO., AND CHAIRMAN, SMALL COMPANY COMMITTEE, UNITED STATES TELEPHONE ASSOCIATION

Mr. PENDERGAST. Mr. Chairman, I appreciate the opportunity to appear before you today. My name is Jim Pendergast and I am president of the San Marcos Telephone Co. in San Marcos, Tex. I am also a member of the board of directors of United States Telephone Association and chairman of the association's small company committee. USTA represents local telephone companies serving more than 99 percent of the access lines in the United States. Its members range in size from the regional Bell companies to the smallest of independents.

San Marcos Telephone Co. is an independent company that provides service to approximately 20,000 customers. I am here to emphasize the adverse effect that H.R. 1049 would have on USTA's 1,050 small telephone company members and their customers.

Like John Hulse, I too testified in 1985 about the effect of tax reform on my company, and I too find it ironic that I have returned 2 years later to defend a provision that has been often misrepresented. Contrary to the claims that this provision was slipped into last year's tax bill, normalization was a subject of full House and Senate hearings, substantial debate in this committee's task force, and appeared in virtually every document produced by the House Ways and Means Committee and Senate Finance Committee during tax reform.

Contrary to rhetoric and myth used to justify this bill's introduction, we have no fleet of corporate jets, we do not own a baseball team, and we are not interested in buying drug stores. This country's more than 1,000 small telephone companies tend to serve mostly rural and small town America, and therefore, provide service to residential customers at a cost which is less than the actual cost of providing that service. The cost recovery programs established by the Congress, the FCC and local commissions have helped finance these costs.

Now after listening to some of the comments and points that were made in some of the testimony and early this afternoon, I think it might be worthwhile to depart from some of my written comments and to try to address a few points that I think need addressing.

The first one is that no one in the utility industry has ever said that we would hold these funds forever. We have always taken the position that they will be returned to the customers over the useful life of the facility. We never had an intent to retain these funds.

Second of all, the deferred tax accounts are accounts that telcos do not earn on. They are no cost to the customer.

Third of all, in most of the small companies, we do not have cash in the coffers where we can automatically make these refunds without going back out to the debt market to borrow these funds to flow through.

And fourth of all, I question whether it is fair to provide a one-time shot to the current ratepayers instead of flowing it through to the ratepayers who will be using these facilities over the life of the facilities.

It will be also important to note, just in our particular case, San Marcos Telephone Co. in 1986 lost about \$350,000 in capital that was derived previously from investment tax credit. I would estimate very quickly that we would have to flow through another \$650,000 to our customers if this bill went through and if we were required to flow it through in a year or 2-year period. That is a total of \$1 million of additional capital we would have to go out for in a 2- or 3-year period, which is a lot of money for a small company.

Another point I think is important to make is that this is—these tax reserves are cost free to the ratepayers. And just by way of an example, if we had a \$1 million rate base that we are entitled to earn on, and we had a \$200,000 tax reserve, you would have to deduct that \$200,000 from the \$1 million to arrive at \$800,000 rate base. If we were entitled to earn 10 percent on that \$800,000, we would be entitled to earn \$80,000.

If we were required to pay that \$200,000 out to the customers, we would no longer have that deduction and our rate base would then be \$1 million. And at 10 percent, we would be required to receive \$100,000 from our customers, whereas the year before we were only receiving \$80,000 from our customers. Inevitably, this can result in an increase to our customers.

And I think the point that was made with the electric industry is apt also to the telephone industry, in that the majority of our customers are residential customers. But I think the majority of the refunds would go to the large business customers. So the people who would pull the load in the future would be the small residential customers.

In summary, in my mind the fallout of this bill would be to increase interest charges to our customers, to increase rate base to our customers, to increase debt nationally at a time when I think none of us want to increase debt. I think it would also produce volatility in rates over a three or 4-year period.

Finally, it seems to me that we are assuming that the benefits that telephone companies are garnering now are going to continue in the next 5 to 10 years. And if we assume that there will be no changes in tax rates, no changes in depreciation rates, no changes in accounting principles, then possibly the arguments that this will be a long-term benefit to the telephone company is true. But I suspect in the next 10 years we will see some significant changes in the tax bill, or tax law rather.

One other consideration is, as we listened this morning, a number of the regulators said that they would flow it through over a short period of time, and others said they would flow it through over a long period of time. You would have 50 different States with 50 different ways of administering federal tax policy.

Those individuals also indicated that they would treat the telephone industry differently than they would treat the rest of the utility industry in their State. They also indicated that they look at companies differently that had cash than companies that did not

have cash. And all of this is really going to affect the customers in this country differently in every State, depending on utility, depending on whether the company has cash or does not have cash. And I wonder whether this is a good way to administer Federal tax policy.

Like John, I agree that normalization has worked in the past. It has worked for accelerated depreciation. It has worked for investment tax credit and will certainly work fairly in this case. The pluses of normalization far outweigh the minuses.

The minuses of H.R. 1049, I feel, work to the detriment of our customers and also to the detriment of the companies.

Thank you very much.

[The statement of Mr. Pendergast follows:]

STATEMENT OF JAMES J. PENDERGAST, ON BEHALF OF THE
UNITED STATES TELEPHONE ASSOCIATION

Mr. Chairman, I appreciate the opportunity to appear before you today. My name is Jim Pendergast, and I am the President of the San Marcos Telephone Company in San Marcos, Texas. I am also a member of the Board of Directors of the United States Telephone Association and chairman of the Association's Small Company Committee. USTA represents local telephone companies serving more than 99 percent of the access lines in the United States. Its members range in size from the regional Bell companies to the smallest of independents.

San Marcos Telephone Company is an independent company that provides service to 20,000 customers. I am here to emphasize the adverse effect that H.R. 1049 would have on USTA's 1,050 small telephone company members and their customers.

Like John Hulse, I too testified in 1985 about the effect of tax reform on my company; and I too find it ironic that I have returned two years later to defend a provision that was a substantive compromise among a mostly negative array of other provisions that fundamentally redesigned the way my company--and indeed America--is taxed. Specifically, telephone companies, like all capital-intensive companies, retroactively lost the Investment Tax Credit in 1986. On the other hand, ratepayers have received all of the benefit from the income tax rate reduction. As a result, telephone company capital investment has fallen seven percent during the first three quarters of 1987.

Today we are discussing the effects of repealing Section 203(e) of last year's Tax Reform Act. This provision allows utilities to give ratepayers the full advantage of previous accelerated tax depreciation benefits over the schedule known at the time the benefits were granted. To do otherwise would be to provide a windfall--to someone.

H.R. 1049 would repeal Section 203(e) and allow state utility commissions to determine how quickly the so-called excess deferred tax reserves will be given to ratepayers by utilities. The repeal of this policy would further restrict capital investment options available to my company under current law and would cause the rates my company charges our customers to rise over the long term.

To understand this, one needs to understand the fragile cost recovery through tax and regulatory treatment upon which a company like mine depends. Because most of my customers are residential consumers--in fact 85 percent of them--my costs of service are much higher than those in a metropolitan area. In order that small company customers receive reasonably priced telephone service, they must be charged rates below the cost of that service. Any businessman serving them would see that as a losing proposition.

However, cost-recovery programs have been established by the Congress, Federal Communications Commission (FCC), Rural Electrification Administration (REA) and local commissions to help finance the high cost of providing service to "small town" and "rural" America.

After the AT&T divestiture, the FCC established a national revenue pooling program to serve as an averaging mechanism to meet the necessary revenue shortfall caused by the inadequacy of customer ratebase revenues. Since 1971 the REA has financed telephone plant construction through credit programs.

As a matter of federal tax policy, the Congress made available to utilities the investment incentives of accelerated depreciation and, until this year, the investment tax credit. As a result of normalization, these investment incentives reduce the cost of capital improvements; without normalization these benefits would simply subsidize current utility rates and deprive future consumers of benefits associated with the incentives to invest in plant and equipment for which they are being charged. As a result, the benefits of tax depreciation are apportioned to all ratepayers over the life of the utility property to ensure that all ratepayers who share in the cost of property also share in the tax benefits related to such property.

These represent the extent of regulatory options available to my company that contribute to the reduction of the high costs of operation. If any one of these components were to be substantially reduced or eliminated, my alternatives would be to raise customer rates, reduce the investment necessary to provide quality telephone service, or lay off my employees.

These alternatives are unacceptable to a responsible business whose long-term goal is to provide quality service at reasonable prices. Current law provides no windfall to any one--it is very much a compromise.

Had Congress mandated that utilities follow Generally Accepted Accounting Principles--as all other corporations do--my company would simply add the so-called excess deferred tax reserve to our income statement as profit, in accordance with the soon-to-be-released statement of the Financial Accounting Standards Board.

H.R. 1049 offers the opposite opportunity--for local commissions to grant large rate decreases to current consumers at the expense of all future consumers.

Last year's tax law has, generally, reduced most utilities' tax expense for ratemaking purposes. It has done this by reducing the corporate tax rate from 46 to 34 percent. This reduction is passed through directly to consumers. It does nothing for utilities. The effects of the other provisions in last year's Tax Reform Act are to eliminate or reduce the tax benefits that provided a source of investment capital that allowed utilities to build the facilities used by subscribers.

The only element of tax policy easing the adverse effect of these provisions is the manner in which utilities can treat their so-called excess deferred tax reserves. The "excess" is a result of the reduction of the corporate income tax rates and its effect on prior depreciation.

By enacting Section 203(e), the Congress recognized that the excess deferred tax reserves provide a source of capital which reduces the cost of financing new plant. Contrary to the assertions of H.R. 1049's advocates, this "excess" is not cash created by Tax Reform. There is no money sitting in a bank account. The so-called excess is only a bookkeeping entry reflecting reduced future tax expense. The revenues represented by this bookkeeping entry have been invested for the benefit of all consumers in plant and equipment used to provide telephone service.

In this way, telephone companies are able to pass on the savings to their customers through rates that are lower than those that they would have to charge if they reflected the costs of debt financing.

Perhaps this would be the principal difference between the effect of H.R. 1049 on small companies such as mine and its effect on large utilities. If I were forced prematurely to give these tax benefits to ratepayers, I would have to borrow to do it. I would have to compete with huge corporations for the additional \$20 billion needed to make these consumer payments. Not all small companies have a "AA" bond rating, as does Pacific Bell. Many small companies might be unable to raise the money at all. If they could, it would cost them and their customers substantially. I guarantee that the long-term cost of higher telephone rates would more than offset the short-term rate reductions possible under H.R. 1049.

Consumers across the country are paying smaller telephone bills because tax reform reduced the corporate tax rate. They do not--and should not--expect an extra immediate windfall that would hurt their telephone companies and themselves.

Mr. Chairman, we are not looking for special treatment. We are not even looking for the same break that unregulated companies are being given. Normalization has served both consumers and utilities well. Changing the law will disturb the balance that was struck in 1986.

In summary, normalization is perhaps the only positive result of tax reform for small telephone companies. It was the subject of hearings in both the House and the Senate and received substantial debate and consideration by the House Ways & Means Committee. Normalization has not hindered the ability of state commissions to conduct massive tax reform implementation proceedings that have resulted in substantial rate reductions in many states. If H.R. 1049 had any merit as federal tax policy, its principal proponent would not have attempted to sneak a new, similar version through the Committee as a "technical correction" during the reconciliation process in October, an attempt the Committee was wise to reject.

Mr. Chairman, I thank you for the opportunity to present these views.

Mr. DORGAN. The Chair would advise members that we have a vote on the floor; about 8 minutes left on the current vote, and a 5-minute vote following. What we would like to do would be to inquire of this panel and then go on to the fishing rights legislation.

The subcommittee will stand in recess until 3 o'clock. If you will be patient and remain with us, we would like to have the opportunity to inquire. The subcommittee will be in recess until 3 o'clock.

[Recess.]

Mr. DORGAN. The subcommittee will come to order. The audience will please take seats.

The Chair will recognize Mr. McGrath.

Mr. McGRATH. Thank you, Mr. Chairman. Thank you, gentlemen.

Mr. Pendergast, you are from a small utility, as your testimony indicated. What kind of an impact would the repeal of section 203(e) have on the ability of a small company like yours to provide a universal telephone system, which Congress has fostered through the Rural Telephone Bank.

Mr. PENDERGAST. We are not a member of the Rural Telephone Bank, but I think that if you have a lot of small companies out there that are very rural, may have 1,000 or 2,000 subscribers, which means they have got an awful lot of capital invested to serve those few subscribers, this could have a pretty big impact on them and force them to go back to the debt markets or back to REA.

They may, in some cases, have difficulty financing the funds needed to replenish what they have paid out by the flowthrough.

Mr. McGRATH. Mr. Hulse, what effect would the repeal of section 203(e) have on the financial markets?

Mr. HULSE. I think that it would have certainly a negative effect. In today's economy and with the uncertainty that exists, any kind of a requirement for our industries to finance up to \$20 billion, I think, would result in higher debt costs to us and a lot of uncertainty about our industries.

Mr. McGRATH. We have heard a lot today about the fact that this provision was inserted in the still of the night without ample reflection by the members of the Ways and Means Committee. I seem to be reflecting on this quite a bit. What support exists in the legislative history for this normalization and section 203(e)?

Mr. HULSE. I think as far as normalization itself, the Treasury testimony summarized it, and I really could not add anything to that. It has been our perception that normalization has been the policy of Congress. Certainly the intent to have the money from deferred taxes used for capital formation has been congressional policy since 1969. I really think it probably goes back to 1954. Since 1969 it has been clear that you would be in violation if you did not use normalization.

Of course, we are the best example of that. In California, we did have an innovative formula that was ordered by the California Public Utilities Commission and we were finally denied our right to take that deferred tax. We had to come back to Congress and eventually get a special exemption to allow us to at least retain the deferred taxes along with a remedial provision clarifying congressional intent. We also paid a significant penalty and a refund through that period of time, so it was very expensive for us.

Our view is normalization has been the policy since 1969 and we saw, and were concerned, that the excess deferred tax reserve follow those same normalization principles, and I testified to that here.

Mr. McGRATH. So the public policy of normalization, allowing normalization, has been with the Congress for at least 19 or 20 years or so.

Mr. HULSE. More importantly, it is something that we depend on. I am responsible for planning the cash-flows to meet our capital requirements. We have had to face the fact that we do not make investment decisions that are 1 or 2 years in length. When we had to revise our estimates because of the investment tax credit being repealed, I have to tell you, to then look at how we are going to deal with the potential loss of another \$600 million is very disruptive to us and our industry.

There is no reason to do it. The normalization requirement we have today is fair for the consumer. It is fair for us, and I think it embraces Congress' intent.

Mr. McGRATH. Mr. Rhinehart, we heard testimony from the electrical producing people today and also the gas producers today, regarding the recent history of the commercial customers going out on their own, producing for their own needs, and bypassing the utilities. I guess we could say the same for the telecommunications aspect of the utility industry that big customers are producing their own in the telecommunications and communications areas, and bypassing some of the regulated utilities.

While we are interested in making sure that the commercial entrepreneurs are in good health because of the jobs that they certainly allow our constituents to enjoy, I am interested in the residential ratepayer. What we have heard about today is a \$19 billion windfall. How much would the residential customers benefit if all of the excess tax reserves in existence today were passed through immediately?

Is there any number out there, as to how much a residential customer would get at this point? Or an average refund?

Mr. RHINEHART. Congressman, let me address that question from the perspective of AT&T. Our revenue requirements, if we had to flowthrough the excess deferred tax reserves, would go down about \$760 million. About 52 percent of that \$760 million, roughly \$400 million, would flow through to the business customer; 45 percent of our \$760 million, or roughly \$340 million, would flowthrough to our residential customers. Now we have some 86 million residential customers and simple division would show that what this would mean to the residential customer is a refund of about \$3.97, one time flowthrough.

The point, and our concern is, that of course then the next year the rates would go back up because of what has been explained by Mr. Pendergast, a loss of the excess tax reserves, the loss of the amortization of the excess tax reserves, and the additional capital cost because we would have to go to the marketplace to replace the capital.

Mr. McGRATH. And the uncertainty whether or not this Congress will increase corporate tax rates, or freeze them at some level?

Mr. RHINEHART. That is exactly right. It was not addressed in the testimony this morning, as to what happens if the corporate income tax rate goes back up. We know very well that we will have deferred taxes and if the corporate rate goes back up, then you are going to have to increase those deferred taxes and that treatment was not recognized at all.

Mr. McGRATH. Thank you. I want to thank the gentleman for testifying before this committee. I will tell you that I probably know more about this subject than I ever wanted to know. [Laughter.]

In my experience, this is not one of those subjects that would be brought to the forefront of my imagination. However, I do think that it is an important subject. I do think that during tax reform in 1986 we made certain gestures toward the regulated utilities, in terms of taking away some of their tax preferences. I have enumerated those in the past.

We also reduced their rates which I guess, in some way, produced this windfall that we have spoken about today. But I think the Ways and Means Committee, over the last at least 20 years, has felt that normalization was a good public policy and I do not see any reason at this time, given the fact that tax reform is just a year or two old, that we should go change it.

Thank you.

Mr. DORGAN. So that means you are on the fence, Mr. McGrath? [Laughter.]

Mr. McGRATH. Stronger language to follow.

Mr. DORGAN. Thank you very much.

I must admit, this is not coffee table talk in North Dakota as well, but it affects every household in your State and mine and is an important subject.

Mr. Andrews.

Mr. ANDREWS. Thank you.

Mr. Rhinehart, expand for me just a little bit more. Let us assume that rates go back up, corporate rates are raised in the next Congress or next year. And let us assume the Dorgan bill passes, think through that for a second for me. What is the effect on AT&T?

Mr. RHINEHART. The issue is how much will the rates go up. Let us say they swing right back up again, from 34 to 46 percent, and we are looking at the same \$760 million increase in our corporate revenue requirement, just the reverse situation. Now the question is what will the public utility commissions do?

We are confronted now with the \$760 million rate increase. Will they somehow let us obtain those funds right away from ratepayers, or will they now employ an amortization or a reverse normalization and give us that additional tax expense over a period of time?

Mr. ANDREWS. Mr. Hulse made a statement in his testimony. He said that it was not fair to pay back the excess deferred taxes to only current customers. I think I heard him correctly. He said that it was fair to pay back the excess deferred taxes over the life of the equipment to those future customers. How is that so?

Mr. RHINEHART. The benefit of normalization is that it allocates the excess deferred taxes fairly and equitably to both current and

future rate payers. If you give all of the tax benefit to current rate-payers, then when the rates go up or you run out of tax depreciation, future rate payers are going to have to pick up that burden. So it is a matter of fairness that we are talking about here.

Mr. ANDREWS. Tell us how much does your company owe consumers in this excess deferred reserve?

Mr. RHINEHART. Approximately \$700 million.

Mr. ANDREWS. If the Dorgan bill was to pass, what do you think would be your best guess on some kind of payback schedule?

Mr. RHINEHART. Very difficult question, one that was talked about a lot during the day. In the past, when the rate reductions went into effect, back in 1979, from 48 percent corporate income tax rate to 46 percent, some commissions required normalization. Some required the flowthrough over a 3- to 5-year period. Some had immediate flowthrough.

So you just do not know how it is going to be interpreted if the bill was passed. We think the most equitable way is to stay with normalization and the average rate assumption method of paying those excess reserves back to our ratepayers.

Mr. ANDREWS. Mr. Pendergast, I am delighted to have you here from Texas today and I appreciate hearing your testimony and your comments about your written testimony. Could you tell me what the Texas State law is on diversification?

Mr. PENDERGAST. We have, if a holding company is formed under Texas law, they would be required to go to the public utility commission to form a holding company. There is also a set of accounting rules. If you do diversify within a regulated telephone company, you have got to make sure that you do not cross-subsidize.

Although you are not prohibited from diversifying, if, for example, there are earnings within the company that would be normally paid out to shareholders and the shareholders would be paid those dividends and those dividends would be reinvested in other businesses, then there would be no prohibition against that.

Mr. ANDREWS. You do not see any problems if, for example, a small company like yours, a small utility company, bought a drug store or invested in an insurance company? Do you see any policy problems with doing that?

Mr. PENDERGAST. I guess I see a policy problem in that for a small company you have got difficult accounting rules to keep track of, different accounting methods to make sure that you do not cross-subsidize your unregulated part of the business, the drug store in this case, with the regulated part of the business, which would be the telephone company.

We have, even as a small company, to avoid those accusations. We have set up different companies that are separate and distinct so that we do not have those accusations of cross-subsidization. It is too complicated to deal with.

Let me just go a little bit further. We have set up some separate companies, within our affiliated company rather, not part of a holding company. If we did not set those companies up and get into these other businesses, we would have had 60 less employees in our town than we have right now. If we did not choose to get in the unregulated terminal equipment piece of the business, or the unregulated long distance piece of the business, or the yellow page

piece of the business, we would have 60 less people working for us now than we do today.

Mr. ANDREWS. Do me a favor, now, please respond to Mr. Hulse's comment in his statement about it not being fair to pay the consumers back these dollars now? Do you agree with that?

Mr. PENDERGAST. Yes, I do. The reason being, if I can just take investment tax credit as an example, because it is something that is a little bit easier to understand.

Mr. ANDREWS. You used accelerated depreciation, too, in your statement, did you not?

Mr. PENDERGAST. Yes, if we have a piece of plant that cost \$1 million and is going to last 10 years, that \$1 million piece of plant is not paid for the first year by our rate payers. It is paid for over a 10-year period because that is the life of it. So the people who were on the system in the beginning and the people who were on the system in the middle and the people who were on the system at the end pay the burden for that piece of equipment.

It is not just the people the first year when we bought that piece of equipment who bear the burden.

The flip would be the same principle for the benefits. The benefits for buying a piece of equipment should not flow through immediately to that first set of ratepayers. It should flow through to all the people who used that piece of equipment over a 10-year period. So the same principle would hold true.

If they have the burdens of depreciation for a 10-year period, they ought to have the benefits of whatever the tax laws provide over that same period of time.

Mr. ANDREWS. How much do you owe consumers?

Mr. PENDERGAST. We have got a deferred reserve of approximately \$5 million.

Mr. ANDREWS. Assume a worst case scenario for me. Assume the Dorgan bill passes and the Texas Public Utility Commission promulgates that you have got to pay this back to consumers on an accelerated basis. Give us your thoughts about the short and long term effects on small utility companies.

Mr. PENDERGAST. There are 67 telephone companies in Texas and just a very quick calculation, I would estimate our flowthrough would be anywhere from \$750,000 to \$1 million which would basically increase our rate base and require us to go back in and ask for another \$150,000 in annual income.

In our State, I am not sure about the other States, piecemeal regulation is unlawful. You cannot just go in and say your tax rate is decreased, therefore flow it through immediately to the ratepayers. If your electric bill is decreased, you cannot flow it through immediately to the ratepayers.

You have got to look at the increases and the minuses and come up with a new rate. I do not think Texas is different from most other States. For us to file a rate case or go through a show cause order or a rate review, would cost us approximately \$125,000 to \$150,000 just for one rate case. That does not count the intervenor's cost, it does not count the public utility commission cost and so on. It does not count the cost of going out and floating new debt.

So in my mind, a flowthrough of this sort would result in a rate increase for our customers and an awful lot of the moneys that

were going to flow to them to begin with would be eaten up in rate-making costs.

Mr. ANDREWS. Let us assume a second hypothetical, then. Let us assume a worst case scenario, an accelerated payback. Let us assume the Congress next year freezes or raises the corporate tax rate. What is the impact on your company?

Mr. PENDERGAST. Again, we would go back in for a rate increase because increases in taxes are not flowed through immediately to the ratepayers. You would have to go back to the public utility commission and justify it. So you would be looking at another rate case process and another request for increased rates to recover the difference between current rates and increased rates.

Mr. ANDREWS. That is all I have, Mr. Chairman.

Mr. DORGAN. Thank you, Mr. Andrews.

Mr. Pendergast, in 1978, when the corporate income tax was reduced, what happened to your company's tax obligation with respect to action by the Texas Public Utilities Commission?

Mr. PENDERGAST. When our rates were reduced in 1978?

Mr. DORGAN. Yes.

Mr. PENDERGAST. You mean did they force us to flow those decreases through?

Mr. DORGAN. Did they force it to flowthrough or did they normalize it?

Mr. PENDERGAST. I would say the latter.

Mr. DORGAN. What happened to that money?

Mr. PENDERGAST. Again, if we just look at one piece of our cost of doing business, which is the tax cost, you could justify a decrease in rates. But what most commissions would do is they would look at your decrease and the income tax expense, and they look at your other increases, in wages and insurance, and so on, and they would make a determination whether the pluses offset the minuses.

Mr. DORGAN. So what did the Texas Commission do?

Mr. PENDERGAST. We file an annual report with the Texas Public Utility Commission. Back in 1978 they obviously looked at our annual report and saw that we were not overearning, even with the new tax rates, and there was no justification for a rate change.

Mr. DORGAN. So in Texas, there were no refunds required. Not flowthrough and not normalization. In fact, you were required to make no refunds with the excess deferred taxes, is that correct?

Mr. PENDERGAST. I am talking about our particular company. If you looked at Southwestern Bell, for example, it represents 90 percent of the access lines in our State. In 1978 they went in for a rate case. The commission took into account the decrease in Federal income tax, and those adjustments were made. So in effect, they were flowed through to the customers.

In our particular case, if our tax rate went down, for example, from 40 to 30 percent which is a 10 percent savings, and we had other costs of doing business that went up a like amount, then that tax savings was really flowed through to the benefit of the customers, and our customers in particular, because without that tax decrease, our rates would have gone up.

Mr. DORGAN. Mr. Pendergast, I think the point I am making is that none of the regulated companies in Texas were required to flowthrough. In fact, they were not even required to normalize be-

cause in 1978 tax reduction, the Texas Commission decided no refunds were necessary, not just for your company but generally across Texas.

The point I am trying to make with that is that you are coming to us today saying let us not trust the Texas regulatory people because of the disastrous things they might do to take that excess deferred taxes and move it in 5, 10, or 3 years, as opposed to normalization.

The only experience your company has had with that was a good one, was it not?

Mr. PENDERGAST. Again, to answer the question, the reason it was not flowed through for the only company that went in for a rate case, in fact the only company that did go in for a rate case that year, which was Southwestern Bell, the differences in tax rates were flowed through to the benefit of the customer and for the other companies that were not called for rate cases.

Mr. DORGAN. I think you are missing my question. I have information here from the National Association of Regulatory Commissions, which is the commission I am talking about in Texas. With respect to the 1978 tax reduction, the excess deferred taxes that resulted from that in the State of Texas were not required to be refunded by your company or other companies in Texas.

My point is that you are, in your testimony today, suggesting somehow that the regulatory authorities in Texas, if given the opportunity under my legislation, would require the flowthrough probably on an accelerated basis and you fear that. My question was, the only experience your company has on this has been a good experience, has it not?

Mr. PENDERGAST. I hate to be argumentative. If we are talking about the flowthrough of the decrease in Federal income tax—

Mr. DORGAN. We are only talking about excess deferred taxes today. We are not talking about all your other costs and expenses. Most of the testimony here has been about the excess deferred taxes and I am saying that the treatment in Texas has been specific and documented. All I am asking you to do is acknowledge that your only experience to date with the Texas regulatory folks has been generally acceptable to you.

Mr. PENDERGAST. It was acceptable because we were not required to reduce our rates because federal income taxes were reduced.

Mr. DORGAN. So you were able to keep the excess deferred taxes that were on hand in your company at that point?

Mr. PENDERGAST. That is correct.

Mr. DORGAN. You did not come to Congress to complain about that. That was an acceptable consequence in terms of where your company was at that point?

Mr. PENDERGAST. That is correct.

Mr. DORGAN. Let me ask you a question on something you referred to in your statement that has piqued my interest. You indicated, in your statement, that the treatment of excess taxes has been long considered and sufficiently discussed as a matter of public policy. Having been a member of the Ways and Means Committee with Mr. McGrath and others, I understand the task forces that were put together and how we did the tax reform bill in 1986.

You referred, at the end of your statement, to something that was related but not the same argument or debate that we are having here today. That is, you have assets in your telephone company that are below the midlife point, and you are able to continue collecting taxes from your customers on that asset not only until you can meet the 34 percent rate obligation, but well above that amount.

I am talking about taxes you will collect next month, the month after that, the month after that, to a point above the 34 percent rate at the asset's mid-life, is that not correct?

Mr. PENDERGAST. Can you give me an example?

Mr. DORGAN. I think I just did. With regard to any asset in your inventory that is below the midlife point you have already collected part of that asset, at the 46 percent rate, and you are going to continue to collect at a rate that is going to get you above the 34 percent rate at the midlife of the asset. The IRS appears to be prepared to rule that it is not in a position to require you to stop collecting above and beyond what your 34 percent tax rate would allow.

I attempted to correct this flaw in the budget reconciliation bill this fall. Joint Tax Committee and others indicated, in fact, that my amendment would have been a technical correction because no one intended that to happen when the Tax Reform Act of 1986 passed.

The process by which I intended to correct that in the reconciliation debate in the Ways and Means Committee was almost exactly the process by which section 203(e) was accomplished. In the instance in which I was trying to correct it recently, you described it as something that was sneaky, but when it came to section 203(e), almost an identical process, you suggested it was thoughtful and deliberative.

Are you being fair in both instances, do you think?

Mr. PENDERGAST. According to my understanding of it, and my recollection of it is that this was talked about, in fact I participated in some of the discussions on it before the House Ways and Means Committee, that it was a deliberative process and that it was not something that was slipped in at the last minute.

My understanding of the bill that was filed as a technical correction was that it was an attempt to put a cap on normalization.

Mr. DORGAN. I guess the point I want to make to you is this. I do not like you coming here suggesting that what we are doing is sneaky, if it is something that you do not like. But if it is something that you enjoy, it is thoughtful and deliberative.

That is not fair, and you are welcome to your views.

Mr. PENDERGAST. I can understand that.

Mr. ANDREWS. Would the gentleman yield for one more question?

Mr. DORGAN. I would be happy to yield.

Mr. ANDREWS. Mr. Pendergast, I meant to ask you this, could you give me an estimate assuming the worst case scenario, assuming you had 12 months to rebate these funds. What would residential consumers get from your company and what would be your estimate of what residential consumers in the state of Texas would receive?

Mr. PENDERGAST. I have no way of guessing the last figure. I can only speak for my company and my estimate would be \$750,000 approximately would be flowed back through to the customers.

Mr. ANDREWS. To how many customers?

Mr. PENDERGAST. We have 20,000 customers, 85 percent of which are residential customers. It depends on the method of flowback. Again, I am not trying to be difficult. If they flow it back strictly on numbers of customers, it would be flowed back primarily to the residential customers.

If they flow it back based on revenues, I would say 60 percent of our revenues come from 5 percent of our customers and they are big business customers. So if the method they used was flowback based on revenues, the majority of it would go to a few business customers.

Mr. ANDREWS. Thank you.

Mr. DORGAN. Mr. Rhinehart, respond if you would to my grandmother, who is 92 years old, who uses her telephone, heat, electric, lives by herself, has paid for the last 20 or 30 years rates that include excess deferred taxes. Will you say to her, you will get this money back some day. Remember, she is 92 years old. She probably would smile a little when you say sometime, 20 or 30 years from now you will get your full check.

Mr. RHINEHART. It is a difficult question to answer because you can come at it from a number of different ways. Let me start by saying that you can look at the intent in the tax law, the tax benefit of accelerated tax depreciation, why is it there. The reason that I understand that it is there is to stimulate capital investment, which in turn stimulates the economy, which is in turn good for our ratepayers.

So that is one way of coming at the question. Another way of coming at the question, if you refund in a relatively short period of time, you create tremendous rate instability with a higher level once you have made that refund, so that future ratepayers are going to be paying at a higher rate.

That is unfair to the young family. You used as an example the senior citizen not being around to get the full benefits of that amortization. But yet, if you flow it all through, you are going to increase rates and that is unfair to that young family.

We believe that the best way to deal with that excess deferred tax reserve is to amortize it over the remaining life of the plant. You are being fair to the current ratepayer and you are being fair to the future ratepayer.

Mr. DORGAN. Just one final question. I understand that answer. It is one that we have moved around today several times. I say again, if I had \$19 billion of somebody else's money, I would fight like the devil to keep as much of it as I could for as long as I could. I understand your position.

But I think you need to understand the young family and my grandmother both would very much like to have that money as soon as possible without creating unstable rates. Making that determination is what we ask regulators to do.

Mr. Hulse, you indicated the question here is who should regulate tax benefits. I do not disagree with that, but I think the point is, these are not tax benefits. The excess deferred taxes are not

taxes any longer. It is money that you have that has to now go back to the customer because the tax rate has decreased and you have a requirement to refund it.

These are not tax benefits. They are going to have to be refunded to the customer precisely because it is not a tax benefit. So I think the issue here is why should we contradict long-standing tax policy and intervene and impede the State regulatory commission's work? That is really, in my judgment, what has happened. That turns the coin on what has been argued here for several hours.

What is the compelling tax policy reason that would persuade you to ask Congress to jump in and impede the work of the State regulatory commissions?

Mr. HULSE. I think the basic reason is because of the lack of consistency, what happened in 1978 was one. We have been concerned, and are concerned, that there be a fair treatment, an equitable treatment of the flowthrough of those tax benefits across all commissions.

I beg to disagree with you, we do look upon them as being tax benefits. We paid them to the Federal Government and you and the Treasury should lay out the ground rules as far as how we give them to ratepayers.

We think dealing with Congress is the right thing, in embracing normalization for disposing of the excess tax reserve is the fairest and most equitable way to do it.

Mr. DORGAN. I appreciate very much your answer and the subcommittee appreciates the testimony of all three members of the panel. It is thoughtful testimony that will contribute to the discussion.

We appreciate your indulgence and attendance today.

That concludes the hearing on H.R. 1049. The Chair would request that Representative Andrews take the chair for the conduct of the hearing on the tribal fishing rights legislation.

[The United States Telephone Association requested that the following be included in the record:]

Dr. James H. Vander Weide
Research Professor of Finance and Economics
Fuqua School of Business, Duke University
February 1988

An Analysis Requested By The U.S. Telephone Association (USTA)

EXECUTIVE SUMMARY

An Economic Assessment of H.R. 1049
Dr. James H. Vander Weide

H.R. 1049, introduced by Congressman Byron Dorgan (D-ND) would repeal Section 203(e) of the Tax Reform Act of 1986. Under current law, Section 203(e) requires that "excess" deferred taxes be passed to ratepayers no faster than over the average life of related assets using the average rate assumption method. Use of this method provides the tax benefits rapidly to telephone ratepayers and provides a matching of the tax benefits with the associated depreciation cost.

A study of the economic implications of passage of H.R. 1049 on telephone customers, federal, state and local governments and the telephone industry was commissioned and this study concludes as follows:

Telephone Customers

Telephone customers would be worse off as a group if H.R. 1049 is passed. The present value of customer payments for telephone service is higher under all of the methods likely to be adopted by regulatory commissions than under current law. If the full amount of excess deferred taxes is flowed through to customers in one year, there would be approximately a \$7.6 billion rate reduction, followed by \$12.8 billion in rate increases in subsequent years. For a \$20 per month phone bill, the customer would get less than a \$2 per month rate reduction for one year. The customer would pay a total of \$40 in increased rates in subsequent years for this refund. In sum, the customer is paying \$40 for a less than \$24 refund and, even on a present value basis, is worse off.

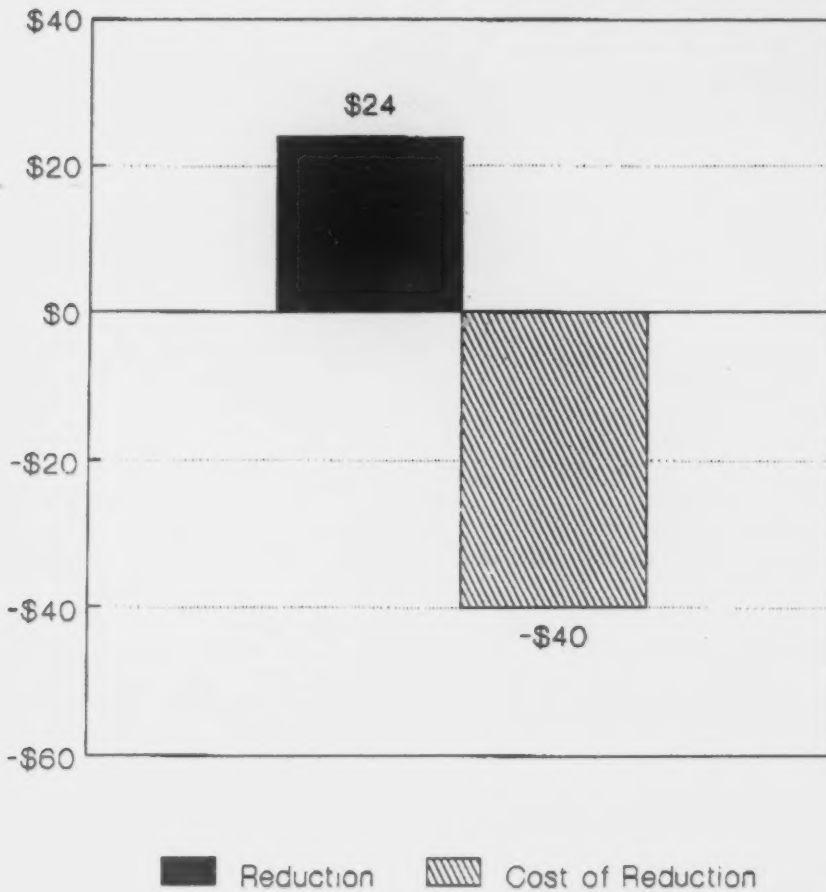
Federal, State and Local Governments

The enactment and implementation of H.R. 1049 would have a significant adverse effect on tax collections of federal, state and local governments. Initially, federal income tax payments from local telephone companies would decline by approximately \$2.7 billion if regulators adopt immediate flow-through. Federal excise taxes are estimated to be reduced by more than \$100 million in the first year. In addition, state tax collections for income, gross receipts and sales taxes would be significantly reduced.

Telephone Industry

A relatively insignificant reduction in each customer's telephone bill in 1988 produces a very significant decrease of \$7.6 billion in total local exchange telephone industry revenues. Although the telephone industry regains these revenues in later years, the negative first-year impact comes at a time when the telephone industry is already experiencing profound changes in competition, regulation and technology. The study shows a dramatic first year \$5.2 billion increase in telephone industry financing requirements, caused by the \$7.6 billion decrease in revenues in 1988, which could have significant adverse impact on capital expenditures and labor costs, as well as the national capital markets.

**H.R. 1049 COULD COST CONSUMERS MONEY
For a Reduction of \$24, Telephone
Customers Would Pay \$40**



Based on a monthly local telephone bill of \$20, a one-time reduction of \$24 would cost each customer \$40.

AN ECONOMIC ASSESSMENT OF H.R. 1049

Dr. James H. Vander Weide

Introduction

The U.S. Telephone Association (USTA) has asked me to study the economic impact of H.R. 1049, as introduced by Congressman Byron Dorgan (D-ND), on telephone customers, the telephone industry, and federal, state and local governments. As part of my study, I have: (1) developed a financial model of the possible differential impact of H.R. 1049 on each of these parties, (2) gathered data from industry participants and other sources to help me measure the magnitude of the impact, and (3) conducted an economic assessment of whether the various parties would be better or worse off if H.R. 1049 is passed.

On the basis of my study, I conclude that the passage of H.R. 1049 and a decision by regulatory authorities to prematurely flow-through "excess"¹ deferred taxes (created by the Tax Reform Act of 1986) could result in the following:

- o An immediate reduction in telephone industry revenues of \$7.6 billion
- o A \$5.2 billion increase in telephone industry financing requirements
- o A \$2.7 billion decrease in U.S. corporate income taxes and a more than \$100 million decrease in federal excise taxes² from the industry.

Even though telephone customers could receive an immediate reduction in telephone bills from the passage of H.R. 1049, telephone rates would increase substantially in later years. For example, the \$7.6 billion reduction in the first year would result in an increase of \$12.8 billion in telephone rates in subsequent years. On a present value basis, telephone customers would be worse off by approximately \$600 million.

Although an analysis of state and local income, sales and gross receipts taxes, was not a focal point of this study, my analysis indicates that collections of these taxes would decline significantly as a result of the passage of H.R. 1049.

My study is divided into four sections. Section I provides some background information about normalization and Section 203(e) of the Tax Reform Act of 1986 [Act]. Section II describes my analysis of the impact of H.R. 1049 on telephone company revenues, financing requirements and tax payments to the federal government. Section III discusses the implications of my economic analysis for telephone customers, the telephone industry and the federal, state and local governments. Section IV contains my conclusions. In addition, an appendix containing a description of the model I relied upon for my conclusions is presented.

¹ It should be noted that the word "excess", commonly used to describe this phenomenon, is a misnomer. It merely defines the difference between the amount of existing reserves and the amount that would have been reserved had the tax rate always been 34%. Deferred taxes have been invested in plant and equipment and do not represent cash on hand.

² Based on an industry survey, between 50 and 60% of the refund would have been subjected to the telephone excise tax.

I. Background of Normalization and Section 203(e)

Starting with the Internal Revenue Code of 1954, U.S. companies have been allowed to use accelerated depreciation for corporate income tax purposes as a stimulus to capital formation. In 1969 Congress recognized that many state regulatory commissions had redirected these federal tax benefits to telephone customers in the form of rate reductions. In order to preserve the original intent of this incentive and to stem the loss of federal revenues, Congress mandated the use of "normalization" for public utilities as a prerequisite for eligibility for accelerated depreciation.

Normalization is a mechanism for sharing tax benefits between utilities and customers so that the public utility enjoys the capital formation incentive and its customers enjoy the long-term benefit of the tax incentive. This sharing is accomplished by matching the tax benefit with the cost of the related assets over their useful life. In this manner, normalization achieves fairness and economic efficiency. It has been a key factor in stabilizing utility rates over a period of years.

Functionally, normalization requires the establishment of a deferred tax reserve. This tax reserve arises as a result of differences between the amount of accelerated depreciation used for tax purposes and the amount of depreciation under regulatory requirements. In the early years of an asset's life, tax depreciation normally exceeds regulatory depreciation and, over time, this situation reverses. Over the asset's life, regulatory and tax depreciation are equal.

Customers receive the full benefit of accelerated depreciation under the normalization method of accounting. Since the tax deferrals resulting from the use of accelerated depreciation are deducted from the rate base, customers receive these benefits over the life of the assets in the form of reduced utility prices.

In the absence of a requirement to normalize, an alternative method of accounting, referred to as "flow-through", has the effect of rapidly flowing through the tax savings from accelerated depreciation to utility customers. This creates an immediate reduction in the utility's revenue requirement. This revenue requirement reduction is offset in the succeeding years of an asset's life by a revenue requirement increase. In addition, flow-through significantly increases the firm's financing requirements and, at the same time, reduces tax collections of federal, state and local governments.

Congress continued the normalization requirements for the newly enacted tax depreciation system in the Tax Reform Act of 1986. It also required normalization treatment for the transitional effect of the corporate rate reduction impact on prior depreciation tax deferrals. The intent was to pass to utility customers any "excess" deferred taxes created by the corporate rate reduction over the life of the assets that gave rise to the depreciation benefits. It is this very provision, Section 203(e) of the Act, that H.R. 1049 proposes to repeal. Repeal of Section 203(e) would allow regulators to circumvent the original capital formation incentives intended by Congress. Instead, these incentives, which have been invested in plant and equipment would be diverted to provide a temporary utility rate reduction.

Section 203(e) of the Act was intended to provide stability and equity for the regulatory process as it relates to the treatment of excess deferred taxes. Flow-through treatment would lead to unnecessary economic fluctuations in utility prices, with current telephone customers being undercharged and future customers being overcharged.

Tax reform, especially the repeal of the investment tax credit, placed a heavy financial burden on public utilities. Unlike unregulated firms, utilities are not able to offset the loss of the investment tax credit with the reduction in corporate tax rates. The benefit of the reduction in the corporate tax rate from 46% to 34% is directly channeled to customers in the regulatory process and leads to lower utility rates. Section 203(e) was designed to ease the transition for regulated public utilities to the tax reform era where investment tax incentives are severely reduced. Its repeal would force the utilities to rely more heavily on external capital financing to replace the capital support lost through a more rapid flow-through of excess deferred taxes than under the average rate assumption method [ARAM].

II. Economic Analysis

The economic analysis reported in this paper is based on a set of equations³ describing a typical telephone company's key financial variables in terms of a small set of known parameters such as: (1) the amount of excess deferred taxes, (2) the time pattern of the amortization of excess deferred taxes under Section 203(e), (3) the allowed rate of return on rate base, (4) the firm's capital structure and (5) the market rate of interest. By obtaining data on values of the known parameters that characterize the telephone industry, it is possible to estimate the economic impact of H.R. 1049 on telephone customers, the telephone industry and the federal government with a reasonable degree of accuracy. The particular parameter values that were used for this purpose are enumerated in Exhibit 1.

H.R. 1049 leaves the regulatory treatment of excess deferred taxes up to regulatory commissions. It is likely that commissions would elect to flow the excess through to customers at faster rates than those allowed in the Tax Reform Act of 1986. When the corporate tax rate was reduced from 48% to 46% in 1979, the regulatory treatment of the excess deferred taxes varied considerably from jurisdiction to jurisdiction. Over 20 states required flow-through of excess deferred taxes in five years or less.

For the purposes of analysis, I compared telephone industry revenues, financing requirements and federal tax collections from the ARAM to three benchmark flow-through assumptions: (1) immediate flow-through, (2) straight line flow-through over three years, and (3) straight line flow-through over five years. The results of these comparisons are shown in Tables 1-3 and Exhibits 1-3. They may be summarized as follows:

I. Revenues

a. Immediate Flow-through

Aggregate industry revenues are lower by \$7.6 billion in 1988 under immediate flow-through as compared to the current policy of flow-through over the remaining life of

³ In developing these equations, I followed the methodology used by Dr. Donald Kiefer in his article entitled, "Accelerated Depreciation and the Investment Tax Credit in the Public Utility Industry: A Background Analysis," April 1979, Dr. Donald W. Kiefer, Occasional Paper No. 1, The National Regulatory Research Institute, the Ohio State University. My model differs from Dr. Kiefer's model primarily in that it explicitly considers possible regulatory treatments of the excess tax reserves that arise when corporate tax rates are reduced. A complete mathematical statement of the model is contained in the Appendix.

the assets (i.e., ARAM). However, aggregate industry revenues are significantly higher in all subsequent years, as customers and the telephone companies replace the lost capital formation incentives. Over the next 19 years, telephone customers would pay \$12.8 billion more for telephone services if immediate flow-through were to be adopted. [See Table 1 attached.]

In present value dollars (using a 10% after-tax cost of capital⁴) this amounts to an \$8.2 billion cost for a one-time benefit of \$7.6 billion.

b. Three-year Flow-through

Under three-year flow-through, aggregate industry revenues are reduced by \$1.9 billion in 1988, \$1.7 billion in 1989 and \$1.4 billion in 1990. However, aggregate industry revenues increase by approximately \$9.2 billion over the next 17 years. [See Table 2 attached.] Thus, telephone customers are approximately \$4.2 billion worse off in absolute dollars and \$418 million worse off in present value dollars⁵ under three-year flow-through than under ARAM.

c. Five-year Flow-through

Five-year flow-through produces a total industry revenue reduction ranging from \$779 million to \$489 million. This time, the subsequent revenue increase amounts to \$6.2 billion over the remaining 15 years. [See Table 3 attached.]

Again, telephone customers are approximately \$3.2 billion worse off in absolute dollars and \$289 million worse off in present value dollars⁶ under the accelerated flow-through approach.

2. Financing Requirements

a. Immediate Flow-through [See Exhibit 1]

The immediate flow-through of "excess" deferred taxes causes total telephone industry financing requirements to increase by about \$5.2 billion in 1988. Higher telephone bills in later years will pay the carrying cost of the up-front financing.

⁴ The impact on consumers is intended to be expressed in real economic terms. The measurement of impact is intended only to represent a realistic gauge relative to the value of timing differences in flow-through methodologies to consumers. To be conservative, a 10% after-tax cost of capital was utilized. In the event customers cannot achieve this return, the cost of H.R. 1049 to them would be significantly higher than indicated in present value terms.

⁵ See discussion under footnote 4.

⁶ See discussion under footnote 4.

b. Three-year Flow-through [See Exhibit 2]

Under three-year flow-through, telephone industry financing requirements increase by \$1.3 billion in 1988, \$1.2 billion in 1989, and \$1.1 billion in 1990. Thereafter, aggregate industry financing requirements are reduced. Higher telephone bills in later years will pay the carrying cost of the up-front financing.

c. Five-year Flow-through [See Exhibit 3]

Increased industry financing requirements range from \$529 million to \$381 million under five-year flow-through compared to ARAM. Higher telephone bills in later years will pay the carrying cost of the up-front financing.

3. Federal Taxes

a. Immediate Flow-through [See Exhibit 1]

Federal tax collections from the telephone industry decrease income tax collections by approximately \$2.7 billion and excise taxes by over \$100 million in 1988 under an immediate flow-through policy. Tax collections from the telephone industry begin to increase in 1989 and remain higher in subsequent years under immediate flow-through as opposed to ARAM.

b. Three-year Flow-through [See Exhibit 2]

Federal tax collections from the telephone industry decrease by \$670 million in 1988, \$608 million in 1989, and \$548 million in 1990, but increase in each of the next 17 years under three-year flow-through. Excise tax collections would also decrease in each of the three years.

c. Five-year Flow-through [See Exhibit 3]

Federal tax collections from the telephone industry decline by approximately \$197 million to \$273 million per year from 1988 to 1992 under five-year flow-through. They increase in all subsequent years. Excise tax collections would also decrease in each of the five years, if the statute is extended.

4. Interest Expense

Telephone industry interest expense is higher in every year regardless of which of the three accelerated flow-through methods is implemented (assuming that the current capital structure ratios and interest rates are maintained).

III. Implications

The above results have a number of implications for each of the major parties affected by H.R. 1049:

- 6 -

1. Telephone Customers

My study indicates that telephone customers as a group would be worse off if H.R. 1049 is passed. The present value of customer payments for telephone service is higher under all of the flow-through methods likely to be adopted by public utility commissions than it is under present policy. Furthermore, the average residential bill initially would be reduced by a negligible amount during the premature flow-through year(s), even under immediate flow-through.

Since the \$7.6 billion industry revenue reduction in 1988 is approximately nine percent of total industry revenues, the typical residential customer that spends \$20 per month for local exchange services would receive a reduction of less than \$2 per month for only a one year period under immediate flow-through. This monthly rate reduction would be even less if made over three to five years. Thereafter, the customer's monthly bill would increase. For a \$2 per month rate reduction in the first year for a total of \$24, the customer would pay a total of \$40 in increased rates in subsequent years. On the whole, customers would be worse off even on a present value basis. From the point of view of the typical residential customer, then, the benefits of H.R. 1049 are indeed illusory.

2. Telephone Industry

A relatively insignificant reduction in each customer's telephone bill in 1988 produces a very significant decrease of \$7.6 billion in total telephone industry revenues. Although the telephone industry regains these revenues in later years as it is compensated for the additional financing costs under immediate flow-through, the negative first-year impact comes at a time when the telephone industry is already experiencing profound changes in competition, regulation and technology. The dramatic first year \$5.2 billion increase in telephone industry financing requirements caused by the \$7.6 billion decrease in revenues in 1988 could deter capital expenditure decisions. This would be especially unfortunate because a healthy, technologically advanced telecommunications industry is a vital part of a modern economy.

3. Federal, State and Local Governments

In addition to its impact on the telecommunications industry, H.R. 1049 could have a significant adverse effect on the tax collections of the federal, state and local governments. The above analysis indicates that federal income tax collections from the telephone industry will decline by approximately \$2.7 billion and federal excise tax by over \$100 million if H.R. 1049 is passed and the commissions adopt immediate flow-through of "excess" deferred taxes.

Although these are not part of my analysis, it is evident that state and local income, sales and gross receipts taxes would decline significantly if H.R. 1049 is passed. These taxes are linked to telephone company revenue, and revenue declines in the early years under all forms of accelerated treatment of "excess" deferred taxes. Thirty-one states apply gross receipts taxes on telephone revenue with an average rate of about 3.5%. About forty-five states impose income taxes and most of those states subject telephone companies to such tax.

Sensitivity Analysis

The preceding analysis is based on an industry composite profile that may not be reflective of each individual telephone firm. To determine whether my conclusions might be altered under a different set of financial assumptions, I performed a sensitivity analysis of my results. In particular, I examined the financial impact of H.R. 1049 for various: (1) allowed rates of return in the range of 11% to 13%; (2) levels of debt ratios from 35% to 50%; and (3) rates of amortization of excess deferred taxes under ARAM. In no case did the results differ relatively from those described above.

IV. Conclusions

On the basis of my economic study, my knowledge of the industry from my 12 years of experience as an expert witness and consultant in telecommunications issues, and my extensive studies of general economic conditions, I conclude that passage of H.R. 1049 would have the following detrimental effects on telephone customers, the telecommunications industry, and federal, state and local governments. As a further result of my study, I have also determined certain negative effects on the U.S. economy as discussed below.

1. Increase in Telephone Rates

My analysis shows that the temporary reduction of telephone rates by \$7.6 billion from an immediate flow-through would result in a long-term increase in telephone rates of \$12.8 billion. In fact, the increase is so large that customers would be worse off on a present value basis if H.R. 1049 were passed and premature flow-through implemented by the commissions.

2. Stability of Phone Rates

It has long been the practice in the telephone industry to subsidize residential rates by pricing certain services, such as long distance, above cost. Now that competition has been introduced into telecommunications, there are strong economic forces driving residential rates towards their costs over time.

If residential rates were raised in the years after an immediate flow-through, the long-run effects of H.R. 1049 combined with natural economic forces in the industry would result in a steep increase in residential telephone rates over time.

3. Capital Formation Incentives

By eliminating the investment tax credit and changing the allowed depreciation lives of certain assets for tax purposes, the Tax Reform Act of 1986 severely reduced tax incentives for capital formation in the U.S. The telecommunications industry was particularly hard hit by the retroactive loss of the investment tax credit because it is one of the most capital intensive industries in the country. The benefits of the corporate tax rate reduction have been passed on to customers and are not available as a source of capital for the telephone companies. H.R. 1049 would create additional disincentives for

capital formation in the telecommunications industry because it would increase the financing required for future capital investments.

4. Effect on U.S. Economy and Governmental Tax Collections

Although the impact of H.R. 1049 on the U.S. economy depends on the reactions of the regulatory commissions, the impact of any premature flow-through would be negative.

For the amount flowed-through to the residential customer, there would likely be: (1) an immediate shift from investment to consumption expenditures; (2) an increase in interest rates resulting from the increased demand for capital relative to the reduction in the supply of capital dollars; and (3) a decrease in tax collections by federal, state and local governments.

5. Ability to Implement Macroeconomic Policies

The Tax Reform Act of 1986 dramatically altered the usual "multipliers" that macroeconomists use to predict the effect of macroeconomic policy. At this crucial juncture in the business cycle, it would be imprudent to introduce additional uncertainty into the macroeconomic policy picture through passage of H.R. 1049.

6. Administrative Cost

If H.R. 1049 is passed, it is likely that the regulatory commission in each jurisdiction would initiate hearings on how to treat the "excess" deferred tax balances. These hearings would be contested, which is particularly expensive for small companies to administer, and of dubious value in light of the higher telephone charges in future years.

QUALIFICATIONS

James H. Vander Weide is a Research Professor of Finance and Economics at the Fuqua School of Business of Duke University. He is also President of Financial Strategy Associates, a firm that provides strategic and financial consulting services to clients in both regulated and unregulated industries. Dr. Vander Weide graduated from Cornell University (B.S. Economics) and from Northwestern University, where he earned a Ph.D. in Finance.

After joining the Duke faculty, Dr. Vander Weide taught courses in corporate finance, investment management, and management of financial institutions on a regular basis. In addition, he has taught a graduate seminar on the theory of public utility pricing and lectured in executive development seminars on the cost of capital, financial analysis, capital budgeting, mergers and acquisitions, cash management, short-run financial planning, and competitive strategy.

In addition to teaching, he has previously submitted testimony and/or testified on regulatory issues before the Federal Communications Commission, the Federal Energy Regulatory Commission, the National Telecommunications and Information Administration and the public service commissions of twenty-six states. Further, he has written research papers on topics such as portfolio management, the cost of capital, capital budgeting, the effect of regulation on the performance of public utilities, and cash management. His articles have been published in American Economic Review, Financial Management, Journal of Finance, Journal of Financial and Quantitative Analysis, Journal of Portfolio Management, Journal of Bank Research, Journal of Accounting Research, Journal of Cash Management, Management Science, Atlantic Economic Journal, Journal of Economics and Business, and Computers and Operations Research. In addition, he has written a book entitled Managing Corporate Liquidity: An Introduction to Working Capital Management and a chapter on "Financial Management in the Short Run" for The Handbook of Modern Finance.

During the last several years, he has served as Program Director of several executive education programs at the Fuqua School of Business, including the Duke Advanced Management Program, the Duke Executive Program in Telecommunications and Competitive Strategies in Telecommunications. He has also developed an annual cost of capital seminar for utility and regulatory personnel that has attracted a national audience.

EXHIBIT 1 Page 1 of 2

IMPACT OF H.R. 1049
Dr. James N. Vander Weide

ASSUMPTIONS:

Immediate Flow Through
Exc. Def. Before t=0
Exc Def. at t=0 (E0)
Rate of Return (r) =
New Tax Rate (z') =
Old Tax Rate (z) =
Cost of Debt (u) =
Debt Ratio (d) =
YRS Flow Through =

6,300,000 (in Thousands)
5,615,820
12.00%
34.00%
46.00%
9.77% (Moody's AA Seasoned P.U. for 1987)
40.00%
1

YEARS	1	2	3	4	5	6	7	8	9	10	11
Amortization Factor (Delta)	0.1066	0.1095	0.1102	0.1102	0.0966	0.0833	0.0710	0.0617	0.0575	0.0564	0.0309
Cumulative Amort. Factor	0.1066	0.2161	0.3263	0.4365	0.5351	0.6184	0.6894	0.7511	0.8006	0.8450	0.8759
Excess Deferred Tax Balance (ET)	5,615,820	4,925,970	4,231,710	3,537,450	2,928,870	2,404,080	1,954,780	1,568,070	1,205,820	976,500	781,830
Change in Revenue Requirements	(7,600,818)	1,941,688	1,736,118	1,623,865	1,395,648	1,183,843	994,111	842,490	743,828	505,341	421,366
Change in Federal Income Taxes	(2,658,897)	560,722	534,052	505,111	435,604	370,543	311,998	265,611	236,880	158,841	132,876
Change in Taxable Income	(7,820,285)	1,649,181	1,570,742	1,485,622	1,281,188	1,089,891	917,640	781,209	696,704	467,179	398,812
Change in Cash Flow	(5,161,388)	1,088,459	1,036,690	980,510	845,586	719,328	605,643	515,598	459,825	308,338	257,936
Change in Interest	219,466	192,507	165,375	138,244	114,460	93,951	76,471	61,200	47,123	38,162	30,554
Change in Federal Excise Tax	(114,012)	27,625	26,042	24,358	20,935	17,758	14,912	12,637	11,157	7,580	6,320

IMPACT OF H.R. 1049
Dr. James H. Vander Weide

EXHIBIT 1
Page 2 of 2

300

YEARS	12	13	14	15	16	17	18	19	20	TOTAL	Discount Factor 10.00000000
Amortization Factor (Delta)	0.0288	0.0193	0.0168	0.0140	0.0133	0.0113	0.0103	0.0084	0.0019	1.0000	
Cumulative Amort. Factor	0.0047	0.0240	0.0408	0.0548	0.0681	0.0794	0.0897	0.9981	1.0000		
Excess Deferred Tax Balance (EI)	600,390	478,800	372,960	284,760	200,970	129,780	64,890	11,970	0		
Change in Revenue Requirements	371,984	261,643	220,666	179,678	159,449	128,847	100,810	82,117	18,136	5,218,810	8564,310
Change in Federal Income Taxes	118,497	82,597	70,071	57,307	51,542	42,004	36,133	27,761	6,166	1,345,519	(8121,273)
Change in Taxable Income	348,521	242,931	206,091	168,550	151,595	123,775	106,276	81,449	16,136	3,957,405	
Change in Cash Flow	230,024	160,334	136,020	111,243	100,052	81,492	70,141	53,889	11,970	2,611,888	(8235,412)
Change in Interest	23,463	16,712	14,375	11,128	7,894	5,072	2,536	468	0	1,261,401	
Change in Federal Excise Tax	5,580	3,925	3,310	2,695	2,392	1,933	1,632	1,232	272	78,282	80,445

IMPACT OF H. R. 10649
 Dr. James R. Vander Weide

3 Year Flow Through	1	2	3	4	5	6	7	8	9	10	11
YEARS											
Excess Deferred Tax Balance (ET)	1,415,820	2,825,970	4,231,710	3,537,450	2,928,870	2,404,060	1,954,780	1,548,870	1,205,820	978,500	781,830
Change in Revenue Requirements	(1,916,263)	(1,679,671)	(1,445,700)	1,623,865	1,395,448	1,183,863	996,111	863,490	743,820	509,341	421,366
Change in Taxes	(670,362)	(608,637)	(567,766)	505,111	435,404	370,563	311,798	265,611	236,880	158,861	132,876
Change in Taxable Income	(1,971,596)	(1,790,110)	(1,611,076)	1,405,622	1,281,168	1,089,891	917,640	787,209	696,706	467,179	390,812
Change in Cash Flow	(1,301,252)	(1,181,673)	(1,063,310)	980,510	845,984	719,328	605,643	515,396	459,825	308,338	257,936
Change in Interest	55,350	110,439	165,375	138,244	116,460	93,951	76,471	61,780	47,125	30,162	30,354
Change in Federal Excise Tax	(28,744)	(25,195)	(21,686)	26,358	20,935	17,758	14,912	12,437	11,157	7,580	6,320

3 Year Flow Through	YEARS										TOTAL	10,000,000%
	12	13	14	15	16	17	18	19	20			
Excess Deferred Tax Balance (Et)	600,300	478,800	372,960	284,760	200,970	129,780	64,890	11,970	0	0	0	0
Change in Revenue Requirements	371,906	261,643	220,666	179,678	159,449	128,847	108,810	82,117	18,156	4,200,188	8418,027	
Change in Taxes	118,697	82,597	70,071	57,307	51,542	42,086	36,133	27,761	6,166	1,082,897	(889,836)	
Change in Taxable Income	348,521	242,931	206,091	168,350	151,595	123,775	106,274	81,649	18,156	3,186,987		
Change in Cash Flow	230,024	160,334	136,020	111,263	100,052	81,692	70,141	53,889	11,970	2,162,092	(8176,388)	
Change in Interest	23,463	16,712	14,575	11,128	7,854	5,072	2,536	448	0	1,015,197		
Change in Federal Excise Tax	5,580	5,925	3,310	2,895	2,392	1,933	1,632	1,232	272	63,083	86,270	

IMPACT OF H.R. 1049
Dr. James H. Vander Weide

5 YEARS Floodback YEARS	1	2	3	4	5	6	7	8	9	10	11
Excess Deferred Tax Balance (EI)	575,820	1,145,970	1,711,710	2,277,450	2,928,870	2,404,080	1,956,780	1,568,070	1,205,820	976,500	781,830
Change in Revenue Requirements	(779,352)	(676,576)	(580,422)	(486,950)	(513,443)	1,183,843	994,111	842,490	743,828	505,341	421,366
Change in Taxes	(272,431)	(245,942)	(220,008)	(196,504)	(213,487)	370,563	311,990	265,611	236,880	158,441	132,876
Change in Taxable Income	(801,856)	(723,361)	(647,316)	(577,953)	(627,903)	1,009,891	917,640	781,209	696,704	467,179	390,812
Change in Cash Flow	(529,225)	(477,419)	(427,228)	(381,449)	(416,416)	719,328	605,643	515,598	459,825	308,338	257,956
Change in Interest	22,503	44,785	66,893	89,003	114,660	93,951	76,471	61,280	47,123	38,162	30,554
Change in Federal Excise Tax	(11,690)	(10,179)	(8,706)	(7,354)	(7,702)	17,758	14,912	12,637	11,157	7,580	6,320

5 YEARS FLOWBACK YEARS	YEARS										TOTAL	10,000,000%
	12	13	14	15	16	17	18	19	20			
Excess Deferred Tax Balance (£1)	600,390	478,800	372,960	284,760	200,970	129,780	64,890	11,970	0		0	0
Change in Revenue Requirements	371,984	261,643	220,666	179,678	159,449	128,847	108,810	82,117	18,136		3,181,566	8,288,807
Change in Taxes	118,497	82,597	79,071	57,307	51,542	42,084	36,133	27,761	6,166		820,275	(862,065)
Change in Taxable Income	348,521	242,931	206,091	168,550	151,595	123,775	106,276	81,649	18,136		2,412,568	
Change in Cash Flow	230,024	160,334	136,020	111,243	100,052	81,692	70,141	53,889	11,970		1,592,296	(8120,481)
Change in Interest	23,463	18,712	14,575	11,128	7,854	5,072	2,536	468	0		768,993	
Change in Federal Excise Tax	5,500	3,925	3,310	2,695	2,392	1,933	1,432	1,232	272		47,723	94,332

Table 1

Change in Revenue Requirements
(\$ Billions)

Years Flow Through = 1

Effect on:	Year 1	Years 2-20	Total (20 Years)	10% NPV
Case				
ROR = 12% % Debt = 35%	\$(7.6)	12.9	\$5.3	0.6
ROR = 12% % Debt = 40%	(7.6)	12.8	5.2	0.6
ROR = 12% % Debt = 45%	(7.6)	12.7	5.1	0.5
ROR = 12% % Debt = 50%	(7.6)	12.7	5.1	0.4
ROR = 11% % Debt = 40%	(7.7)	12.4	4.7	0.2
ROR = 13% % Debt = 40%	(7.5)	12.2	5.7	0.9

Table 2

Change in Revenue Requirements
(\$ Billions)

Years Flow Through = 3

Effect on:	Year 1	Year 2	Year 3	Total (20 Years)	10% NPV
Case					
ROR = 12% % Debt = 35%	(1.9)	(1.7)	(1.4)	4.3	0.5
ROR = 12% % Debt = 40%	(1.9)	(1.7)	(1.4)	4.2	0.4
ROR = 12% % Debt = 45%	(1.9)	(1.7)	(1.5)	4.1	0.4
ROR = 12% % Debt = 50%	(1.9)	(1.7)	(1.5)	4.1	0.3
ROR = 11% % Debt = 40%	(1.9)	(1.7)	(1.5)	3.8	0.2
ROR = 13% % Debt = 40%	(1.9)	(1.6)	(1.4)	4.6	0.7

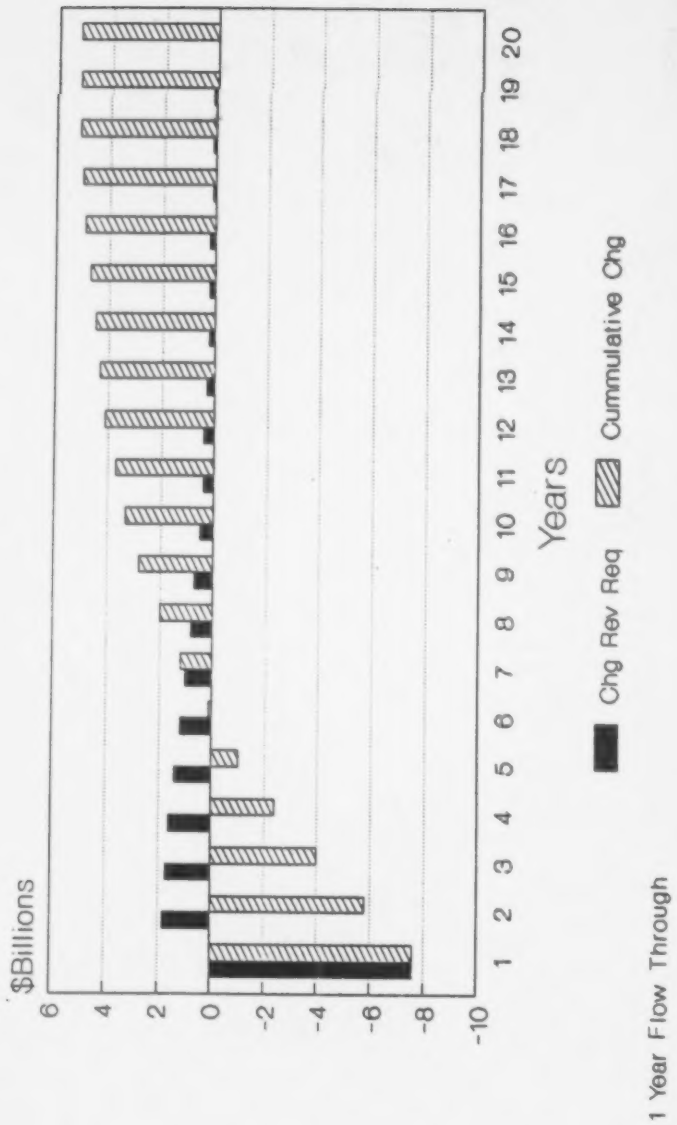
Table 3

Change in Revenue Requirements
(\$ Billions)

Years Flow Through = 5

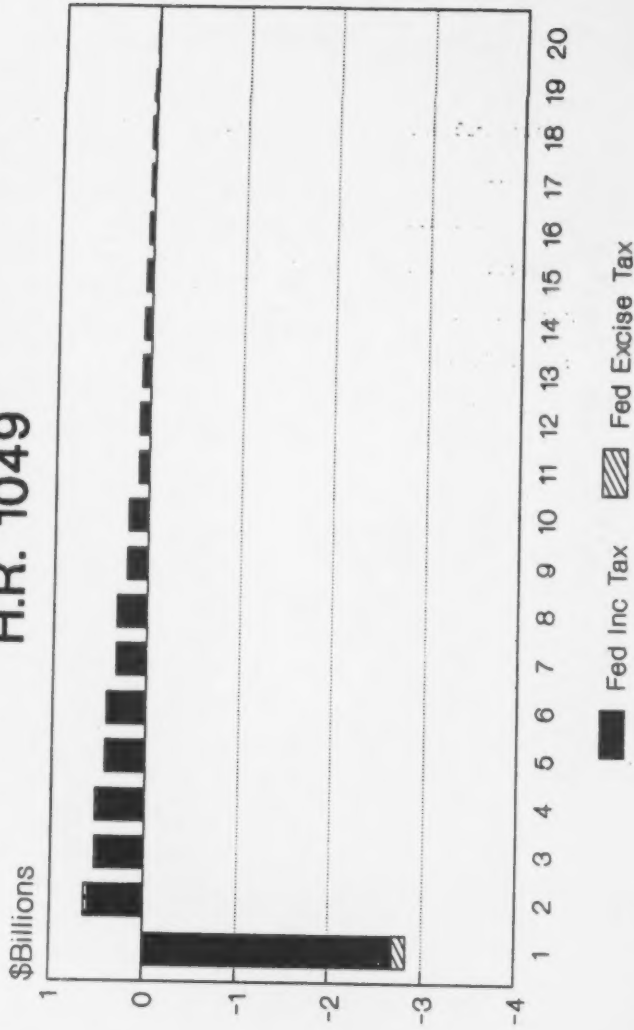
Effect on:	Year 1	Year 2	Year 3	Year 4	Year 5	Total (20 Years)	10% NPV
Case							
ROR = 12% % Debt = 35%	(0.8)	(0.7)	(0.6)	(0.5)	(0.5)	3.2	0.3
ROR = 12% % Debt = 40%	(0.8)	(0.7)	(0.6)	(0.5)	(0.5)	3.2	0.3
ROR = 12% % Debt = 45%	(0.8)	(0.7)	(0.6)	(0.5)	(0.5)	3.1	0.3
ROR = 12% % Debt = 50%	(0.8)	(0.7)	(0.6)	(0.5)	(0.5)	3.1	0.2
ROR = 11% % Debt = 40%	(0.8)	(0.7)	(0.6)	(0.5)	(0.6)	2.9	0.1
ROR = 13% % Debt = 40%	(0.8)	(0.7)	(0.6)	(0.5)	(0.5)	3.5	0.5

REVENUE REQUIREMENT IMPACT ON THE TELEPHONE INDUSTRY H.R. 1049



CHANGE IN FEDERAL INCOME TAX PAID AND EXCISE TAX COLLECTED BY LOCAL EXCHANGE INDUSTRY

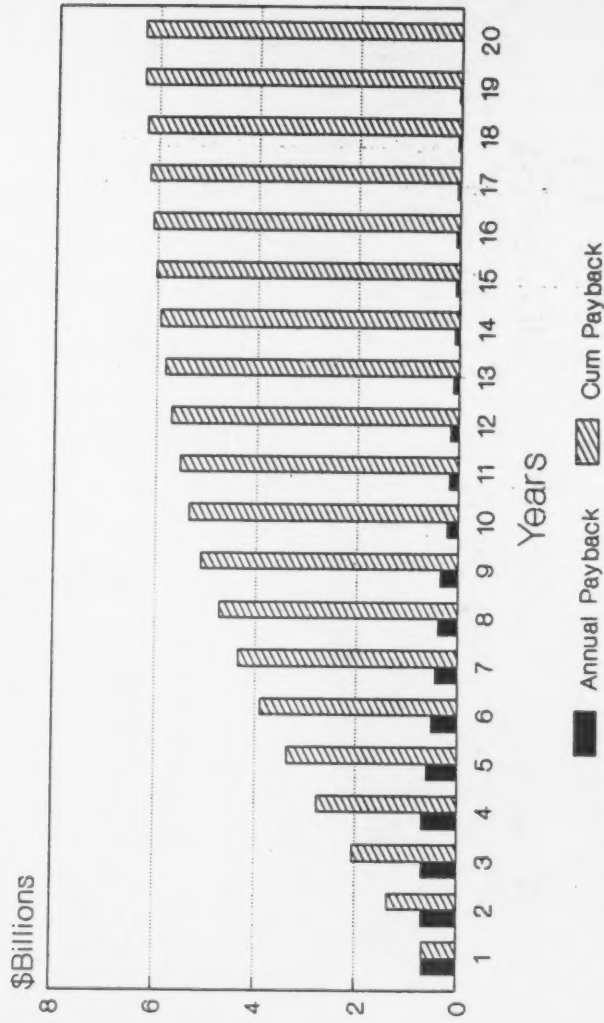
H.R. 1049



1 Year Flow Through

ARAM PAYBACK

Business as Usual w/o H.R. 1049



ARAM - Ave rate assumption method

APPENDIX

The Appendix provides the equations underlying the financial analysis described in the body of this paper. It is organized into three sections. Section I provides equations for the telephone company's revenues, taxable income, taxes, cash flows, and interest expense under the assumption that excess deferred tax reserves are flowed through immediately in the year ($t = 0$) that a tax change is announced. Section II provides similar equations under the assumption that excess deferred taxes are amortized over the remaining life of the company's assets. Section III provides equations for the differential impact of immediate flowthrough versus normalization. Finally, Section IV provides equations for determining the differential impact of other accelerated flowthrough methods versus the Average Rate Assumption Method.

I. Flowthrough

Consider the telephone company's revenues, R_0 , during the first year after the tax decrease is announced. In a regulated environment, these obviously depend on the firm's allowed rate of return, r , the net book value of its plant in service, V_0 , the old and new tax rates, z and z' , the initial balance in the deferred tax account, B_0 , the amount of straight line

depreciation, D_0^s , the amount of accelerated depreciation, D_0^a , the firm's operating expenses, C_0 , and the firm's taxes, T_0 .

Assume that excess deferred taxes are flowed through to customers immediately. Then, the firm's revenues in period $t = 0$ can be stated as follows:

Revenues = authorized rate of return $\times$ adjusted book value rate base
 + amount of straight line depreciation
 + operating expenses
 + taxes
 + tax savings on use of accelerated depreciation in first period
 - excess deferred tax balance at beginning of period 0.

This can be written in symbols as:

$$(1) R_0 = r \left[V_0 - \left(\frac{z'}{z} \right) B_0 - z' (D_0^a - D_0^s) \right] + D_0^s + C_0 + T_0 + z' (D_0^s - D_0^a) - \left(\frac{z-z'}{z} \right) B_0$$

Comments

Several explanatory comments about equation (1) are in order.

1. The book value of the firm's beginning-of-period rate base has been "adjusted" both for (a) the new correct level of deferred taxes, $\frac{z'}{z} \cdot B_0$, and (b) the tax savings on the use of accelerated depreciation in the first period following the reduction in the tax rate, $z' (D_0^a - D_0^s)$.

2. The tax savings on the use of accelerated depreciation is included in the cost of service because normalization of deferred taxes is required even assuming flowthrough of "excess" deferred taxes under the H. R. 1049. Note, however, that because the new deferred taxes are deducted from rate base, the firm earns no return on this loan from the government.

3. The entire balance of "excess" deferred taxes, $\frac{z-z'}{z} \cdot B_0$, is deducted from the cost of service immediately.

Likewise, the firm's taxable income, Y_0 , taxes, T_0 , cashflow, F_0 , and interest expense, i_0 , can be stated as:

$$(2) Y_0 = R_0 - D_0^a - C_0 - i_0$$

$$(3) T_0 = z'Y_0$$

$$(4) F_0 = Y_0 - T_0 + D_0^a$$

$$(5) i_0 = u \cdot d \cdot [V_0 - (\frac{z'}{z})B_0 - z'(D_0^a - D_0^s)]$$

where u is the rate of interest and d is the percent of debt in the firm's capital structure. Deferred taxes are treated as a reduction of rate base.

Evidently, the equations describing the firm's financial variables would be identical in periods after $t=0$, except that the term, $\frac{(z-z')}{z} B_0$ would be eliminated from equation (1) because there are no excess deferred taxes left to flow through to customers.

Although it appears that equations (1) through (5) can be used to find the firm's key financial variables directly, this is not true. The problem is that equations (1) - (3) are interdependent: revenues depend on taxes, taxable income depends on revenues and taxes depend on taxable income. Stated alternatively, equations (1) - (3) cannot be written in such a way that only one unknown variable appears on the left side of each equation and only known parameters appear on the right-hand side of each equation.

Fortunately, the problem of interdependency in equations (1) - (3) can be overcome by solving this system of three equations in three unknowns simultaneously. When this is done, we obtain a unique solution for each unknown variable in terms of the basic parameters. This results in equations for revenues, taxes and taxable income which reflect the tax gross up factor. Since we are really only interested in the differential impact of H.R. 1049, however, we shall leave this step for Section III of this Appendix.

-5-

II. Normalization

Assume now that excess deferred taxes are amortized or "normalized" over the life of the firm's assets. Then, the firm's revenues in period $t=0$ can be stated as:

$$(6) R_0 = r [V_0 - \left(\frac{z'}{z}\right) B_0 - z'(D_0^A - D_0^S) - E_0] + D_0^S + C_0 + T_0 + z'(D_0^A - D_0^S) - \delta_0 \left(\frac{z-z'}{z}\right) B_0$$

and the firm's other financial variables can be stated as:

$$(7) Y_0 = R_0 - D_0^A - C_0 - i_0$$

$$(8) T_0 = z' \cdot Y_0$$

$$(9) F_0 = Y_0 - T_0 + D_0^A$$

$$(10) i_0 = u \cdot d \cdot [V_0 - \left(\frac{z'}{z}\right) B_0 - z'(D_0^A - D_0^S) - E_0]$$

$$(11) E_0 = (1 - \delta_0) \left(\frac{z-z'}{z}\right) B_0$$

where E_0 is the unamortized balance of the excess deferred tax reserves, and δ_0 is the percent of the initial excess deferred tax reserve that is amortized in the first year.

Again, some explanation may be in order. Let's begin with the revenue requirements equation, which is obviously similar in form to the revenue requirements equation in Section I. The difference stems from the fact that only a fraction of the excess deferred tax reserve is flowed through to customers in the first year, while the remainder is deducted from rate base. The remaining equations are also similar in form to those in Section I. However, the interest expense equation recognizes that the firm's rate base is lower under normalization of excess deferred taxes than under flowthrough and an additional equation is required to define the unamortized balance of excess deferred tax reserves.

The equations describing the firm's key financial variables in periods $t > 0$ are virtually identical to those for $t = 0$. The only exceptions are: (a) the amortization coefficient in equation (6) will change from period to period and (b) the cumulative amortization must be accounted for in equation (6) and (11). Thus equation (11) becomes:

$$(11') \quad E_t = 1 - \sum_{0}^t \delta_t \left(\frac{z - z'}{z} \right) E_0$$

III. Difference

To measure the difference between flowthrough of the excess deferred tax balance and normalization, we need to subtract

each Section II equation from its counterpart in Section I. The result is a considerable simplification of the original equations because many terms cancel. If we let the Greek letter, Δ , indicate "difference," then the differential impact of flowthrough versus normalization is given by:

$$(12) \Delta R_0 = r \cdot E_0 + \Delta T_0 + \delta_0 \left(\frac{z-z'}{z} \right) B_0 - \left(\frac{z-z'}{z} \right) B_0$$

$$(13) \Delta Y_0 = \Delta R_0 - \Delta i_0$$

$$(14) \Delta T_0 = z' \cdot \Delta Y_0$$

$$(15) \Delta F_0 = \Delta Y_0 - \Delta T_0$$

$$(16) \Delta i_0 = u \cdot d \cdot E_0$$

By solving this system of equations simultaneously, we obtain a set of equations for each unknown difference variable in terms of our basic set of known parameters. These equations are:

$$(17) \Delta R_0 = u \cdot d \cdot E_0 - \left(\frac{1}{1-z'} \right) \cdot [u \cdot d \cdot E_0 - r \cdot E_0 - \delta_0 \left(\frac{z-z'}{z} \right) B_0 + \left(\frac{z-z'}{z} \right) B_0]$$

$$(18) \Delta T_0 = - \frac{z'}{1-z'} [u \cdot d \cdot E_0 - r \cdot E_0 - \delta_0 \left(\frac{z-z'}{z} \right) B_0 + \left(\frac{z-z'}{z} \right) B_0]$$

$$(19) \Delta Y_0 = - \frac{1}{1-z'} [u \cdot d \cdot E_0 - r \cdot E_0 - \delta_0 \left(\frac{z-z'}{z} \right) B_0 + \left(\frac{z-z'}{z} \right) B_0]$$

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$$(20) \Delta F_0 = - [u \cdot d \cdot E_0 - r \cdot E_0 - \delta_0 \left(\frac{Z-Z'}{Z} \right) B_0 + \left(\frac{Z-Z'}{Z} \right) B_0]$$

$$(21) \Delta I_0 = u \cdot d \cdot E_0$$

$$(22) \Delta E_0 = (1 - \delta_0) \left(\frac{Z-Z'}{Z} \right) B_0$$

Equations (17) - (22), and their counterparts for time periods $t > 0$, are the ones we used to conduct the financial analysis described in this paper.

IV. Other Flowthrough Alternatives

Section III presented equations for the difference in the firm's key financial variables under (1) immediate flowthrough of "excess" deferred taxes and (2) a particular amortization of "excess" deferred taxes, such as that implied by the Average Rate Assumption Method (ARAM). Suppose instead that one is interested in comparing two alternative amortization methods, e.g., a 3-year straight line amortization and ARAM. Then, the following sequence of calculations produces the correct comparison:

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1. Use equations (17)-(22) to compare immediate flowthrough with ARAM.
2. Use equations (17)-(22) to compare immediate flowthrough with 3-year straight line amortization, say,
3. Subtract the results produced in Step 2 from the results produced in Step 1. The difference is the desired comparison.

To see that the above sequence works, let the letters I, A, and T represent a particular financial result under immediate flowthrough, ARAM and 3-year amortization, respectively. Then, Step 1 produces I-A, Step 2 produces I-T, and Step 3 produces $(I-A) - (I-T) = T-A$.

Mr. ANDREWS [presiding]. If we could start, please.

Our first witness this afternoon is Hon. Michael Lowry. It is good to have you here. This is your legislation, your bill, please proceed.

**STATEMENT OF HON. MIKE LOWRY, A REPRESENTATIVE IN
CONGRESS FROM THE STATE OF WASHINGTON**

Mr. LOWRY. Thank you, Mr. Chairman, members of the committee, for granting a hearing on this important legislation. I have a prepared statement and I would like to ask unanimous consent that it be entered into the record.

Mr. Chairman, the legislation before us today, H.R. 2792, which Senator Evans from our state addressed earlier in the proceedings, is to stop the IRS from their present efforts to impose taxes on tribal fisheries that are protected by a treaty signed by the United States and Northwest tribes over 127 years ago.

Specifically, those treaties, which were referred to as the Treaties of Friendliness, were the result of the United States and Indian Nations in the Northwest negotiating so that we could have settlements and progress ahead within the Northwest.

The treaty tribes granted rights to the United States in those treaties. Those rights essentially allowed about 90 percent of the land area in the Pacific northwest to be open for settlement.

In exchange for the granting of those rights to the United States by the Indian treaty tribes, the treaties protected the traditional hunting and fishing grounds of the Indian tribes, as well as other rights.

We have had over seven cases in the U.S. Supreme Court and many other legal cases or legal opinions that have always clearly maintained that treaty rights are not taxable, unless specifically stated so by Congress, and no such statement exists.

What is going on at this time is the IRS is disregarding that situation and the treaty obligation of the United States and has been proceeding ahead, trying to tax the income from this treaty protected right of the Indian nations. What H.R. 2792 does is tell the IRS not to do that, to go along with the agreements that this country made in good faith.

My bill is identical to the legislation that passed the Senate, that Senator Evans introduced. He has been the leader on this issue, and I am glad that Senator Evans was here earlier to speak to that.

[The statement of Mr. Lowry follows:]

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Congress of the United States
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Testimony Submitted by Congressman Mike Lowry in Support of H.R. 2792

before the Subcommittee on Select Revenue Measures

House Committee on Ways and Means

December 14, 1987

Mr. Chairman, on June 25 I introduced H.R. 2792 for myself and Representatives Chandler, DeFazio, Miller (CA), Morrison (WA), Sikorsky) and Miller (WA). Other members who have cosponsored the bill are Representatives Berman, Matsui, Richardson, Ford (TN), Johnson (SD), Campbell, Synar, Oberstar, and Russo. The bill was jointly referred to the House Committee on the Interior and the House Committee on Ways and Means. On ~~July~~ 21 the House Interior Committee ordered the bill to be reported. *Sgt.*

H.R. 2792 would end efforts by the Internal Revenue Service to impose taxes on tribal commercial fisheries that are protected by treaties signed by the federal government and Pacific Northwest Tribes in the 1850s. I urge you and the other members of the Subcommittee on Select Revenue Measures to act favorably on the bill and to aid in its swift consideration by the full Committee.

The treaties that the Northwest Tribes signed with the federal government reserved the right of the Tribes to harvest fish in their "usual and accustomed grounds and stations." And the federal courts have construed the treaties "not as a grant of rights to the Indians, but a grant of rights from them -- [and] a reservation of those not granted."

Moreover, the tribal treaty fishing rights have been upheld by the Supreme Court seven times in this century. It is clear that treaty rights are not a benevolent gift given to the Tribes by the United States. Rather, they are rights that were consciously and purposefully reserved by the Tribes and their people for the benefit of future generations. Similar treaty rights exist in Oregon, California, and in the Great Lakes States. It is imperative that these treaties be honored by our nation.

Since 1982, the IRS has attempted to impose federal income taxes upon tribal commercial fishermen of the Lummi Indian Tribe of Washington State, a signator to the 1855 Point Elliot Treaty. The Lummi fishermen have exercised treaty rights under tribal regulation in areas reserved and protected by their treaty. The unprecedented action by the IRS, coming 127 years after ratification of the treaties by the Senate, does not recognize that treaty-protected property of tribal members is held for them by their Tribes. Moreover, the Lummi tribal government was never consulted on this matter on a government-to-government basis.

The IRS bases its tax claim against Lummi fishermen on the 1982 Earl v. Commissioner case. Mr. Earl, an Indian not then enrolled in a Tribe, working as a cook on a non-Indian fishing boat, was brought into tax court by the IRS. By the time he reached court, Earl had enrolled in his Puyallup Tribe. He represented himself, claimed tax immunity as an Indian, and lost the case. With this and another weak case as precedents, the IRS began efforts to tax other individuals whose fishing activities were truly protected by Indian treaties.

The Interior Department, the federal agency that provides the executive branch with expertise on American Indian law, strongly opposes the IRS (Treasury Department) position. The Justice Department supports the IRS position. It ruled in 1985 that the IRS opinion was the "sounder view of the law," contending that the the Tribes should have foreseen and protected themselves against the 1913 enactment of the 16th amendment to the Constitution — the amendment that established the federal income tax system. I believe that the Justice Department's contention is ludicrous. It is wholly unreasonable to expect that the Northwest tribes could have looked into the future in the 1850's and anticipated the enactment of the 16th amendment to the Constitution some 60 years later.

During the 99th Congress, 33 Senators sent a bipartisan letter to the Justice Department describing the Department's opinion (given established Indian Law and court opinions) as "seriously flawed." The letter urged the Department "to reverse this ill-advised policy without delay." When the Justice Department failed to act on the Senators' request, an Indian fishing rights amendment was attached to H.J. Res. 668, the Debt Ceiling Act, to stop the IRS action. However, for reasons unrelated to the merits of the Indian fishing rights language, all amendments were stripped from H.J. Res. 668.

S. 727 was introduced early in the 100th Congress by Senators Evans, for himself and Senators Bradley, Inouye, DeConcini, Adams, and McCain to reverse the Justice Department's policy. It passed the Senate on March 13 by voice vote. Because the S. 727 deals with possible revenue generation — in this case less than \$125,000 at most -- it must originate in the House.

I introduced H.R. 2792 to satisfy this procedural requirement and to reconfirm long-standing federal policy and principle that was distilled in a 1925 opinion by then-U.S. Attorney General John G. Sargent. He noted that:

general acts of Congress do not apply to Indians unless so worded as to manifest a clear intention to include them; that Indians have always been the object of special legislation, and that general legislation, and especially revenue laws, which burden and restrict the use and enjoyment of property should not be applied to Indians, unless Congress in clear and unambiguous language so directs."

The supremacy of treaty law is quite clear.

Fortunately, despite the differences between agencies, the Administration now supports the Interior position and favors passage of my bill. Assistant Secretary of the Interior for Indian Affairs Ross Swimmer clarified this point in his testimony before the Senate Select Committee on Indian Affairs in March during consideration of S. 727. He also testified in favor of the bill before the Interior Committee earlier this year. Accordingly, the IRS has tentatively agreed to cease all collection efforts against tribal fishermen pending congressional action but has continued litigation against Indian fishermen in U.S. Tax Court. This agreement is an unacceptably fragile safety net for the Tribes.

The swift passage of my bill will send an unequivocal message to the IRS about the sanctity of treaty fishing rights. It will also avoid continued hardship for the affected treaty-protected fishermen. The treaty Indian fishing industry is the central economic activity for most Pacific Northwest Indian tribes and the only source of employment for many tribal members. I urge the members of this Committee to act favorably on H.R. 2792 without amendment so that it can be considered swiftly by the full House.

Mr. ANDREWS. Congressman, just a couple of quick questions, if I might ask, which Indians does this legislation cover?

Mr. LOWRY. It would be frankly all Indians protected by treaty rights within the United States, but this problem specifically has been with those treaties in the Northwest that were signed in the 1850s.

Mr. ANDREWS. Where must the fishing activity take place?

Mr. LOWRY. Within their traditional treaty tribal fishing grounds, as specified by the treaties.

Mr. ANDREWS. Does the fishing activity include canning and selling?

Mr. LOWRY. It certainly can include that, being the tribal activity only. Remember, this is referring only to the tribal activity. That is an important thing to remember as we go through the testimony.

Mr. ANDREWS. Is a corporation exempt? Is that covered by this legislation?

Mr. LOWRY. A corporation would not be a U.S. treaty or tribe.

Mr. ANDREWS. Or a partnership?

Mr. LOWRY. That would not be—this is only the U.S. tribal relationship within the treaty.

Mr. ANDREWS. What if an Indian fishes on a non-Indian boat?

Mr. LOWRY. That would not be covered, or vice versa, which is a case that is brought up many times by people trying to move away from what the real objective and what the real problem is.

Mr. ANDREWS. Explain this to me. I heard it earlier and I am not clear about this, but if their income is exempt, the Indians will not receive Social Security benefits.

Mr. LOWRY. That, frankly, is totally irrelevant to this question. This is income that is not taxable by the United States because of existing treaty agreement. Most treaty fishermen actually do that on a part time basis or have other jobs and those jobs, most of them would be covered by Social Security and for those benefits that they paid in on, they would be subject to Social Security benefits.

Mr. ANDREWS. Is it the intent of your legislation to relieve Indian fishermen only from income tax liabilities, but to continue to impose Social Security and employment insurance taxes on such income?

Mr. LOWRY. No. The intent of the legislation is to stay consistent with the treaty agreement of the United States and the Indians and it has consistently been ruled that that is nontaxable. That would include Social Security or any other item, referring to this tribal treaty income. That is all we are referring to in this legislation.

Mr. ANDREWS. Thank you. Mr. Flippo.

Mr. FLIPPO. Thank you very much, Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman.

Mr. ANDREWS. Our next witness is Mr. Ragsdale. This is W.P. Ragsdale, Deputy Assistant Secretary for Indian Affairs. You may proceed, sir.

STATEMENT OF W.P. RAGSDALE, DEPUTY ASSISTANT SECRETARY FOR INDIAN AFFAIRS (OPERATIONS), U.S. DEPARTMENT OF THE INTERIOR, ACCOMPANIED BY DAVID ETHRIDGE, OFFICE OF THE SOLICITOR, AND GARY RANGEL, CHIEF, BRANCH OF FISH AND WILDLIFE, BUREAU OF INDIAN AFFAIRS

Mr. RAGSDALE. Thank you, Mr. Chairman.

Good afternoon. I am pleased to testify on behalf of the Interior Department on H.R. 2792. With me here are David Ethridge of the Interior Department's Solicitor's Office, and Gary Rangel, Chief, Branch of Fish and Wildlife for the Bureau of Indian Affairs.

My statement has been submitted for the record so I will simply summarize its contents. We support the enactment of H.R. 2792. It would resolve a great deal of concern about taxation of income earned from the exercise of legitimate treaty fishing rights.

The Department has consistently supported and believes that the exercise of these fishing rights should not be taxed. This bill would change a current Justice Department ruling that allows the IRS to assess these taxes.

Many individual Indians rely on fishing for sustenance livelihood. During the treatymaking era, the rights of tribes to continue their traditional livelihood were reserved in perpetuity, to which the United States agreed, in exchange for the tribe's territory.

The courts have consistently affirmed fishing rights of the tribes. Consequently, it seems fair that individuals should continue to exercise these fishing rights without the imposition of taxes. It is our belief that lifting this tax burden would be at a minimal cost to the Federal Government. Moreover, it serves the President's own Indian policy of developing reservation economies and, in fact, the development of fishing resources was noted in the written statement to the Nation on January 24, 1983.

Thank you. We will be glad to answer your questions.

[The statement of Mr. Ragsdale follows:]

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STATEMENT OF W. P. RAGSDALE, DEPUTY ASSISTANT SECRETARY - INDIAN AFFAIRS (OPERATIONS), DEPARTMENT OF THE INTERIOR, BEFORE THE HEARING OF THE SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ON H.R. 2792, A BILL "TO CLARIFY INDIAN TREATIES, EXECUTIVE ORDERS, AND ACTS OF CONGRESS WITH RESPECT TO INDIAN FISHING RIGHTS."

December 14, 1987

Good morning, Mr. Chairman and Members of the Committee. I am pleased to be here to present the views of the Department of the Interior on H.R. 2792, a bill "To clarify Indian treaties, executive orders, and Acts of Congress with respect to Indian fishing rights."

We support enactment of H.R. 2792 which would resolve an issue of great concern to Indian fishing tribes throughout the country, and which is an immediate concern of the Lummi Tribe and other Pacific Northwest fishing tribes: The taxation of income earned by tribal members exercising their fishing rights.

H.R. 2792 would amend the provision codified in 25 U.S.C. 71 to provide that any treaties, executive orders, and Acts of Congress under which the fishing rights of any Indian tribe are secured shall be construed to prohibit the imposition, under Federal or State law, of any tax on income derived by an Indian from the exercise of those rights.

Recent opinions of the Solicitor, Department of the Interior, asserted that commitments made to Indian tribes preclude Federal taxation of income derived from the exercise of fishing rights. Last year, Secretary Model wrote to the Attorney General expressing the Department's concerns about such taxation, stating that the imposition of such a tax would represent an attack on the unique relationship existing between the United States and the tribes, and mark an abrupt departure from President Reagan's Indian Policy Statement of January 24, 1983. Correspondence to the Department of the Treasury also made clear the Interior Department's position on this issue.

As you know, the Internal Revenue Service is charged by the Congress with the responsibility of interpreting and applying the tax laws set forth in the Internal Revenue Code. It determined that income derived personally by a restricted Indian in the exercise of fishing rights is taxable unless the applicable treaty contains language conferring an income tax exemption. The review of the positions of the Department of the Interior and Internal Revenue Service undertaken by the Department of Justice pursuant to Executive Order NO. 12146 and 28 CFR 0.25, concluded that the Internal Revenue Service position is the sounder view of the law. The Department of Justice ruling maintains the IRS position that income earned from the exercise of Indian fishing rights is subject to Federal taxation. H.R. 2792 would change applicable law to provide that the income derived from such Indian fishing would no longer be subject to Federal taxation.

Generations of American Indians have developed lifestyles, cultures, religious beliefs and customs around their relationships with fisheries resources. Historically, these resources provided food and tools, and were traded for a variety of goods. They continue to provide a base of sustenance, cultural enrichment and economic support for many tribes, and help maintain tribal social structure and stability by permitting gainful employment in traditional desirable occupations.

At the time Indian treaties were signed, many tribes reserved to themselves the right to fish in perpetuity. Additionally, and as partial compensation for the land ceded by the tribes, the Federal Government has assumed a trust responsibility that guarantees Federal protection of Indian fishing rights. By the terms of their treaties the tribes shared a resource that they alone had previously used. It seems unfair to us to require them now to share, through the imposition of Federal taxes, the proceeds from the part of the fishery that it was agreed they would retain for themselves. The Indians who were parties to the treaties thought they would be able to continue to fish and trade fish as they had in the past, when they did not pay taxes, and were not required in any way to turn over a portion of their catch to the Government. Some courts have precluded states from taxing Indian fishing activities. I believe that the Congress should apply the same rule to the Federal Government.

Lifting this tax burden will, at minimal cost to the Federal Government, contribute to the implementation of the President's policy in support of the development of Indian reservation economies. The President noted in his policy statement, which was announced on January 24, 1983, that tribal fishing resources provide an avenue of development for many tribes. He initiated an effort to identify and remove Federal barriers to the development of tribal resources and to create a positive environment for the development and growth of reservation economies.

This concludes my prepared statement. I will be happy to answer any questions the Committee may have.

Mr. ANDREWS. I just have one. Can you tell me what the revenue estimate is?

Mr. RAGSDALE. We do not have an accurate estimate of the total revenue for the treaty fisheries.

Mr. ANDREWS. Would anyone on the panel, care to comment, is the revenue loss approximately \$70,000 to the Treasury?

Mr. RAGSDALE. Mr. Chairman, it is my understanding that it would depend. Our current estimate is that for all of the major treaty fishing right tribes across the Nation, which would be the Great Lakes region, the Northwest part of the country, and the north central California area, that the total estimate would not exceed \$200,000.

Mr. ANDREWS. Thank you, Mr. Ragsdale.

Mr. Flippo.

Mr. FLIPPO. No questions, Mr. Chairman.

Mr. ANDREWS. Thank you.

Our next panel is representatives of the Lummi Indian Tribe, the Native American Rights Fund, the Northwest Indian Fisheries Commission, Tulalip Tribes of Washington, Makah and Tulalip Indian Tribes.

If we could, why do we not proceed. Mr. Frank, would you like to go first, please?

STATEMENT OF BILLY FRANK, JR., CHAIRMAN, NORTHWEST INDIAN FISHERIES COMMISSION

Mr. FRANK. Mr. Chairman, my name is Bill Frank. I am chairman of the Northwest Indian Fish Commission, which we have 20 tribes in the Northwest, and we call the Case area. That is Puget Sound in the State of Washington.

We have here today a panel, and hopefully we can all get through here fairly soon and I understand we have 5 minutes. We have the chairman of the Tulalip Tribe, Stan Jones and we have a member and representative of the Lummi Tribe.

We have the Native American Rights Fund here representing, and Mr. Morisset on the end representing the Tulalip Tribe, one of our attorneys in the Northwest.

You have our testimony, from the Northwest Indian Fish Commission. It is basically similar to the one that was introduced on the House side. I will not go into any part of it, because other statements will be made, but one statement I would like to make today would be on the Social Security and the unemployment tax.

I heard, in the a.m., in front of the committee this morning was the Treasury Department. We understand that the Treasury Department has raised concerns over the application of Social Security and unemployment tax laws to treaty fishing income.

Our understanding of the treaties is that no Federal taxes were to be imposed on the exercise of the fishing right. This would include Social Security, unemployment, and income tax.

From a culture standpoint, tribal members who choose to exercise their treaty fishing rights clearly want to do so free from the Government interference. They understand they will not be covered by laws which apply to other kinds of jobs. This is acceptable, as consistent with our treaties.

I want to just explain something right there. Some of our Indian people have jobs, like everybody else. They are linemen. They work for the system in the State of Washington, and they have chosen to go that direction. They have chosen to pay Social Security tax like everyone else.

They have not chosen, and although they have the treaty right of Medicine Creek or any one of our five treaties in the Northwest, to do whatever they want to do, but they have chosen to take that path and they pay tax and they pay Social Security and unemployment tax like everyone else.

The treaty tribes that we are talking for is the people that have chosen to exercise their treaty rights, whether it be hunting, shellfish, salmon fishery that we are talking about right here today, and following that way, of their traditional ways, more or less, of their culture and how they live.

Indian people in the Northwest, they fish and they trade or barter, however, that fish because their people fished. That was the way of their life. They dug clams not because everybody else was digging clams and shellfish, because they are Indians.

They have hunted up in the mountains and different areas because they are Indian people and they live like Indian people. Even though today we have different ways of exercising different rights now on our watersheds and throughout the fishery, we still follow that method of a way of life and that is what we are talking about here.

I just wanted to kind of tell you a little bit about some of our people that are living, and some of them exercise their rights but some of them are living within the Government and the State of Washington laws and paying taxes.

I appreciate being here today and telling you some of the things of our people out in the Northwest. Thank you.

[The statement of Mr. Frank follows:]



Northwest Indian Fisheries Commission

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Testimony of Billy Frank, Jr.
Chairman, Northwest Indian Fisheries Commission
Before The
Select Revenue Measures Subcommittee
of the House Ways and Means Committee
Regarding H.R. 2792, Indian Fishing Rights Legislation
December 14, 1987

As Chairman of the Northwest Indian Fisheries Commission, I appreciate the opportunity to present verbal and written testimony before this Subcommittee representing the twenty Boldt Case Area Tribes of the Puget Sound and Washington coastal areas. The importance of H.R. 2792 "to clarify Indian treaties, executive orders, and Acts of Congress with respect to fishing rights" is obvious for our Tribal governments and their respective Tribal fishermen.

In the Pacific Northwest, fishing has been an integral element of our Tribal cultures and economies for many centuries. In the mid-1850's, Governor Stevens negotiated treaties with our forefathers whereby vast areas of land and natural resources of incalculable value were ceded to the United States in exchange for reservation lands, support provisions, and protection from non-Indian encroachments. We are a fishing people and each of our treaties:

Treaty of Medicine Creek, December 26, 1854
Treaty of Point Elliott, January 22, 1855
Treaty of Point No Point, January 26, 1855
Treaty of Neah Bay, January 31, 1855
Treaty of Olympia, July 1, 1855 and
January 25, 1856

contained the language: "The right of taking fish at usual and accustomed grounds and stations is further secured to said Indians, in common with all citizens of the Territory...." This Tribally-reserved treaty right was specifically mentioned in each treaty to ensure commercial, ceremonial, and subsistence fishing rights for our future generations.

Pacific Northwest Indian Tribes have always known fishing as integral to our lives. The opinion by Interior Department Solicitor William H. Coldiron of September 21, 1983 on "Federal income taxation of Stevens treaty fishing income" is instructive on our reliance on fishing for commercial purpose and our explicit references to reserved fishing rights in our treaties: Coldiron states:

"The fishing rights reserved by the Indians in the treaties included not only the right to fish for subsistence purposes but the right to fish for commercial purposes. At the time of the treaties, the Indians fished commercially, as recognized by the Supreme Court: "Fish constituted a major part of the Indian diet, was used for commercial purposes and indeed was traded in substantial volume." Fishing Vessel, *supra*, 443 U.S. at 665. Quoting from the district court's opinion, the Court described the Indians' reliance on fish for commercial purposes in more detail:

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"At the time of the treaties, trade was carried on among the Indian groups throughout a wide geographic area. Fish was a basic element of the trade. There is some evidence that the volume of this intra-tribal trade was substantial, but it is not possible to compare it with the volume of present-day commercial trading in salmon. Such trading was, however, important to the Indians at the time of the treaties. In addition to potlatching, which is a system of exchange between communities in a social context often typified by competitive gifting, there was a considerable amount of outright sale and trade beyond the local community and sometimes over great distances. In the decade immediately preceding the treaties, Indian fishing increased in order to accommodate increased demand for local non-Indian consumption and for export, as well as to provide money for purchase of introduced commodities and to obtain substitute non-Indian goods for native products which were no longer available because of the non-Indian movement into the area. Those involved in negotiating the treaties recognized the contribution that Indian fishermen made to the territorial economy because Indians caught most of the non-Indians' fish for them, plus clams and oysters." 443 U.S. at 665-666, n.7.

"The Court went on to find that, "During the [treaty] negotiations, the vital importance of the fish to the Indians was repeatedly emphasized by both sides, and [Governor Stevens'] promises that the treaties would protect that source of food and commerce was crucial in obtaining the Indians' assent." 443 U.S. at 676. The Supreme Court's conclusion that the treaty reserved to the Indians a right to take up to 50% of the available fish incorporates the Court's recognition of the role of fish in the Indians' economy and its recognition that the treaty negotiators understood that role and intended that the right to fish commercially was to be included in the rights reserved to the Indians." Interior Department Solicitor William Coldiron Opinion (9/21/83) (pp. 3-4)

The treaty-reserved fishing rights language and intent are indeed clear. Preserving and protecting our tribal fishing rights against non-Indian encroachment and diminishment has unfortunately been a continuing struggle for each succeeding Tribal generation. Seven times in this century we have defended our Tribal fishing rights in the Supreme Court. Five times in the last decade we have fought legislative attempts to diminish or extinguish our fishing rights. Environmental degradation, mismanagement of the salmon resource, and unregulated international interception of our salmon in this century further depleted this Tribal resource. And finally, the Internal Revenue Service arbitrarily decided in 1982 that Tribal fishermen's income, derived from commercially fishing in treaty-designated waters, is subject to Federal taxation.

We have successfully stopped and, in some cases, reversed these legal, legislative, and environmental onslaughts targeting our treaty rights and fisheries resources. Federal District Judge George Boldt in the 1974 landmark decision in U.S. v. Washington, reaffirmed Tribal treaty-protected fishing rights and interpreted the treaty language, "in common with," to mean share equally. This decision, which confirmed the treaty tribes' rights to half of the harvestable salmon and steelhead returning to the usual and accustomed fishing grounds located off the reservations within the designated treaty areas, was upheld twice in the Supreme Court. Legislative attempts to abrogate our fishing rights were effectively halted. Cooperative Tribal initiatives in fisheries management and enhancement, with Washington State as well as local commercial/recreational fisheries interests, have dramatically improved Indian/non-Indian relationships and focused our mutual

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attention on this renewable resource. Tribal participation has become integral to the fisheries management decision-making process at the state, regional, and international levels. The anadromous salmon resource is a mutual concern.

The Internal Revenue Service actions create new hardships, suspicions, and challenges for Tribal governments protecting their treaty fishing rights and resources. Tribal fishermen, licensed and managed by the respective Tribal governments, were just beginning to earn self-supporting livelihoods fishing in their usual and accustomed waters in the early 1980's. In many instances, Tribal governments tax the income of their commercial fishermen and reinvest the revenue into resource management and enhancement. The Reagan administration's White House Indian Policy of January 1983 promoted a "government-to-government" relationship between the United States and American Indian Tribes. IRS agents, after 130 years of a treaty relationship, have reached beyond the Tribal government jurisdiction and attempted to impose Federal taxes on Tribal fishermen's income derived from fish caught in usual and accustomed treaty-designated waters.

The Interior Department, serving as trustee for Tribal resources, has adamantly opposed the IRS actions as unlawful. In 1983, Interior Solicitor Coldiron stated in his legal opinion:

"It is my opinion that fishermen who are members of tribes that have established treaty rights are exempt from federal income tax on fishing income earned pursuant to those treaties."

The Treasury Department Solicitors, of course, interpreted the law through the narrow view of tax policy.

The IRS legal position rests its case principally on a 1982 Tax Court decision, *Earl v. Commissioner*, 89 T.C. 1014 (1982). In this case, an American Indian, not enrolled in an Indian Tribe at the time of arrest, serving as a cook on a non-Indian fishing boat, represented himself before the Tax Court with no attorney. As Interior Solicitor Coldiron observed in his 1983 opinion: "It could not be expected, of course, that the Tax Court, which normally does not interpret treaties, would have, on its own, any appreciable familiarity with the long and complex litigation involving the Stevens treaties." The IRS arrogantly continued its efforts against Tribal fishermen summoning them to tax court and levying assessments.

This intra-departmental dispute between the Interior and Treasury Departments continued into 1985. Interior Secretary Model in a February 22, 1985 appeal letter to Treasury Secretary Baker contended: "This issue has been examined and a conclusion reached that as a matter of law treaty fishing was tax exempt." Model attempted to resolve the issue "in a fashion that recognizes the special obligations of the United States to the Indian Tribes." The Treasury Department did not respond.

Interior Secretary Model wrote Attorney General Meese in the enclosed March 22, 1985 letter seeking a resolution of the Department's legal disagreement. Model included a March, 1983 response to the IRS by Interior Solicitor Richardson with his letter to Attorney General Meese. Richardson reasons that the IRS opinion was based solely on tax law and did not consider treaty law. Richardson supported fully the previous Coldiron opinion and noted:

This is not only a tax issue however; it is also an Indian treaty issue. There are two bodies of law which must be considered in relation to each other.

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December 14, 1987

Two federal agencies with separate responsibilities for distinct elements of United States law were obviously at a stalemate.

The Justice Department in December, 1985, rendered its judgement that the IRS position was "the sounder view of the law." The Justice Department reasoning was that if Federal income tax exemption was not mentioned in the treaties, Tribal fishermen would be subject to Federal taxation.

Obviously, our forefathers in negotiating treaties with the United States, reserving the right to fish to their Tribes, never envisioned that the United States would have the right to impose taxes sometime in the distant future. The treaties were signed in the 1850's; the first Federal income tax laws were established in 1913. Basic canons of American Indian law are that the treaties are to be interpreted as the Indians understood them at the time. Federal taxation was simply not a concept of consideration. Why would the Tribes so explicitly reserve unto themselves fishing rights except that it was a principle sovereign right to a resource? And why would the United States observe that right for over 130 years and then suddenly reverse its legal posture through manipulated interpretation unless the right was emerging as having economic value? This Treasury/Justice Department initiative is a blatant attempt to diminish a Tribal resource and violate treaty rights under the guise of Tax Court legal interpretations.

The Justice Department opinion favoring a Treasury Department ruling which clearly avoids consideration of Tribal Treaty rights has angered Tribal governments, nationwide. Senator Bill Bradley sent a July 17, 1986 letter to Attorney General Meese with 32 Senate co-sponsors representing bi-partisan support on this issue. This letter states, in part:

Based on established Indian law and court opinions, we find the Justice Department reasoning seriously flawed.

The treaty between the Lummi Tribe and the United States Government dates from 1855. Indian tribal resources, reserved in their treaties, should not be subject to Federal taxation. In the President's Indian Policy statement of January, 1983, he spoke of "government-to-government" relations with Indian Tribes. Given this policy, it is certainly difficult to understand how the United States can impose taxes on the resources of these tribal governments without their advice and consent.

We urge you to reverse this ill-advised policy without delay. The Department of Interior estimates that the tax revenue is small, roughly \$70,000 per year. What is at stake, however, is much more substantial. The United States policy of respect and support for treaties with American Indian tribes is an international display of our Nation's commitment to justice and human rights. American Indian treaties should not be subject to further erosion through unilateral reversals of long-established principles.

The Justice Department responded that this was an issue for Congress or the Courts to decide. And that, of course, is why we are here today.

American Indian people pay Federal income taxes like everyone else. In fact, Tribal fishermen whose income is derived from commercial fishing outside their usual and accustomed fishing areas pay Federal taxes. This unprecedented attack on a Treaty-protected tribal resource is viewed by Tribal leaders as a calculated attempt to openly take tribal property. Although these government agents contend that the economic diminishment of a resource is not a diminishment of the treaty right, we contend

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that this Federal intrusion, circumventing Tribal governments to tax the income derived from a treaty-designated resource, is certainly violating our basic treaty rights.

Tribal governments own the treaty-protected resources and are the only legitimate government to impose taxes on Tribal member income generated from the resource harvest. Interior Secretary Model stated the basic issue quite succinctly in his March 22, 1987 letter to Attorney General Meese on this issue:

"Diminution of the treaty fishing rights through the imposition of a tax not only represents an attack on the unique relationship existing between the United States and Stevens Treaty Tribes, but marks an abrupt departure from President Reagan's January 24, 1983, Indian Policy Statement which reaffirms the Federal Government's commitment to that relationship and to the trust responsibility involving Indian natural resources, and, which further, encourages the development of strong reservation economies."

The taxes that would be available to the IRS are estimated between \$70,000 and \$120,000 annually. The majority of Tribal fishermen, according to a 1981 survey of Lummi Tribal fishermen, earned \$6000 to \$10,000 as documented in the enclosed 3/22/85 letter from Interior Secretary Model. Since no Federal income taxes were applied to these fishermen in the past, records from catches are the only data available. The commercial fishing industry is known for the extensive expense due to equipment damage or loss. These normal tax deductions were not afforded tribal members brought to tax court due to insufficient records, however the tax assessments & penalties were based solely on income. This vindictive IRS approach has literally devastated fishermen and their capacity to earn a livelihood.

The Internal Revenue Service continued efforts to summon Tribal fishermen to U.S. Tax Court and collect taxes while this issue is before the U.S. Congress and the Administration witnesses support this legislation publicly is most disturbing. The Senate co-sponsors of S. 727 effectively stopped IRS collection efforts against Pacific Northwest Tribal fishermen with an appeal letter to IRS Commissioner Gibb on April 13, 1987. The IRS Assistant Commissioner for collections responded on May 12, 1987 that:

The Service will withhold collection on any open case of this kind for a reasonable period of time in order that Congress can consider the bill.

The IRS persists, unfortunately, to press its cases against Tribal fishermen in U.S. Tax Court and has expanded its Treaty violation activities to the Great Lakes region.

The Northwest Indian Fisheries Commission endorses the purpose and intentions of H.R. 2792 as introduced and we are certainly encouraged by the expressed support of the House co-sponsors. I testified before the Senate Select Committee on Indian Affairs on a similar provision, S. 727 on March 27, 1987 which passed the Senate on May 13, 1987. The House Interior and Insular Affairs Committee held a hearing on H.R. 2792 on July 21, 1987 and favorably passed the bill that day under unanimous consent. It should be noted that Interior Department Assistant Secretary Ross Swimmer, representing the Reagan Administration, testified in support of S. 727 and H.R. 2792 at these hearings. And, support from the total

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December 14, 1987

Washington Congressional delegation is heartening as demonstrated in the enclosed August 6, 1987 letter to Chairman Rangel of this Subcommittee.

We are concerned that the rather sweeping language of the legislation may expose Tribes and their fishermen to future IRS intervention through regulatory interpretations. Our hope is that the Congressional legislation designed to stop these IRS treaty violations will clearly express Congressional intentions for the faceless bureaucracy either by statute or report language. As stated repeatedly, we expect this legislation protecting our treaty rights to be broadly interpreted. As a guide, we would offer the following basic definitions:

a. "Indian" means a duly enrolled member of an Indian Tribe, and any corporation, partnership or other business entity one hundred percent (100 %) owned by such Indian.

b. "Fishing activity" means the rearing for harvest, the harvest or capture, by net, hook, spear, traps or weirs of fish, shellfish, and other marine species of faunal or floral life, including assisting another Indian in such activity, where such fishing activity takes place within historical fishing places of the tribe or within the exterior boundaries of a federally recognized Indian reservation or at usual and accustomed places within or without an Indian reservation. Fishing activity further includes buying, selling, re-selling, fish or fish products to a processor, warehouse, trader, exporter, retailer or ultimate consumer when such activity is undertaken by an Indian or Indian Tribe.

c. "Usual and accustomed place" includes all places, grounds, stations, sites and locations secured to Indians by treaty, executive order or congressional enactment for the benefit of Indians.

d. "Assisting" includes an Indian working as a crew member on a boat or vessel owned by an Indian or Indian Tribe, and an Indian working as an employee of an Indian or Indian Tribe when engaged in a fishing activity.

e. "Indian Tribe" means federally recognized Indian Tribe with fishing rights secured by treaty, executive order or Congressional act, and includes business entities such as corporations, partnerships and joint ventures one hundred percent (100%) owned by such tribes.

I hope the membership of the Committee on Ways and Means understand clearly that in our Treaties with the United States we reserved for ourselves certain rights and privileges. The United States Supreme Court stated its opinion regarding treaty fishing rights in the 1905 case of United States v. Winans:

"The right to resort to the fishing places in controversy was a part of the larger rights possessed by the Indians, upon the exercise of which there was not a shadow of impediment, and which were not much less necessary to the existence of the Indians than the atmosphere they breathed.

The reservations [of fishing rights] were in large areas of territory, and the negotiations were with the tribe. They reserved rights, however, to every individual Indian, as though named therein.

And the right was intended to be continuing against the United States...

198 U.S. at 381-2 (emphasis added)

NWIFC Testimony on H.R. 2792 -7-

December 14, 1987

This mischevious burden created by the U.S. Tax Court has caused so much financial and emotional misery among our people. I urge the Committee on Ways and Means to support our treaty rights and pass H.R. 2792 expediently.

In conclusion, Tribal governments are becoming increasingly concerned and frustrated by the repeated attempts to control and reduce Tribal treaty-protected rights and resources. The arsenal of strategies designed to reduce or eliminate our treaties is amazing in its breadth, persistence, and inventiveness. We, as ancestors gone before and generations unborn, will effectively defend our rights and resources. We are deeply appreciative of those in Congress willing to help us.

Thank you.

THE SECRETARY OF THE INTERIOR

WASHINGTON
March 22, 1985

Honorable Edwin Meese
Attorney General of the United States
U.S. Department of Justice
Washington, D. C. 20530

Dear Mr. Attorney General:

We are writing to advise you of the Department's concern about the Federal income tax status of treaty fishing income earned by members of tribes whose right to fish commercially is guaranteed by treaties negotiated with the United States during the 1850's, and about a conflict in the positions of this Department and the Department of Treasury on this matter. In 1983, former Solicitor Caidron of this Department concluded that the commitments made to the tribes in those treaties precluded Federal taxation of income derived from the exercise of the treaty fishing rights. That opinion has since been reaffirmed. The Department of the Treasury does not share our view, and the IRS, which began enforcement efforts against certain tribal fishermen in early 1982, continues to press these efforts. We remain in contact with the Department of the Treasury on this matter, but it is not clear that our two Departments will be able to resolve the issue. It is conceivable, therefore, that the Department of Justice will eventually be required to resolve it in order to arrive at the proper position for the United States to take as litigation progresses in U.S. District Court.

The Stevens treaties have been interpreted by the Supreme Court to reserve to the Indians the right to fish commercially. Limited only to the extent that non-Indians must also be afforded the opportunity to fish and that Indian treaty fishing may be regulated by the states (or Federal Government) for resource conservation purposes, Indians who were parties to the Stevens treaties understood that they would be able to continue fishing and trading fish without, in any way, having to turn over to the Federal Government a portion of their catch. Elimination of the treaty fishing rights through the imposition of a tax not only represents an attack on the unique relationship existing between the United States and Stevens Treaty Tribes, but marks an abrupt departure from President Reagan's January 24, 1983, Indian Policy Statement which reaffirms the Federal Government's commitment to that relationship and to the trust responsibility involving Indian natural resources, and, which further, encourages the development of strong reservation economies.

It is evident that a decision to honor the commitments made by the United States in the Stevens treaties would not result in a significant loss of tax revenue to the United States. Data generated by the Lummi Tribe in a 1981 commercial fishing loan study reveals that, based on generous estimates, the potential tax revenue which could be derived from all Lummi tribal fishermen, in an above average fishing year, would approximate \$70,000. Potential revenue which would be derived from taxing all treaty fishing income for all tribes would probably not exceed \$120,000 annually.

In 1981, approximately 1,000 Lummi tribal members received licenses to fish. \$63,000 were sold to fish, and 322 members (nine percent of tribal enrollment) were considered full-time fishers. Total fishing fleet also involved 279 vessels, including 210 skiffs and 52 purse seine vessels. Only 125 skiff owners, 45 skiff operators and 19 purse seine vessel owners made more than 20 trips. The skiff fleet's gross income in 1981 averaged \$6,000/vessel, and ranged from \$400 to \$25,000 per vessel. The average skiff net fisher operated at a net loss in 1981. The purse seine fleet's gross income in 1981 averaged \$172,000/vessel, and ranged from \$22,000 to \$347,000 per vessel. Tribal fisher operators who fished, but did not own boats, in 1981, averaged \$5,000 in gross income. The 1981 study classified approximately ninety percent of the Lummi fleet as impoverished, yet the Lummi Tribe is the most efficient treaty fishing tribe in the State of Washington.

At our request, the Solicitor has reviewed the IRS legal opinion of November 23, 1983, issued in response to Solicitor Caidron's opinion. For your information, we are enclosing Solicitor Caidron's opinion, the IRS response, and Solicitor Richardson's review of the IRS opinion.

Sincerely,

Charles Paul Hodel
LEONARD P. HODEL

Enclosures

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Congress of the United States

House of Representatives

Washington, DC 20515

COMMITTEE
BUDGET
MERCHANT MARINE AND FISHERIES
BANKING, FINANCE AND URBAN
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August 6, 1987

The Honorable Charles B. Rangel
Chairman
Subcommittee on Select Revenue Measures
House Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Rangel:

We are writing, as members of the Washington State Congressional delegation, to request the earliest possible consideration on H.R. 2792, a bill iterating that treaty-protected resources of American Indians cannot be taxed by the federal, state, or local governments. We ask that you request referral of H.R. 2792 to your Subcommittee and act quickly to pass H.R. 2792 to the full Ways and Means Committee.

H.R. 2792 was introduced on June 25 and referred jointly to the Ways and Means Committee and the Committee on Interior and Insular Affairs. On July 21, the Interior Committee approved the bill by unanimous consent. Ross O. Swimmer, the Assistant Secretary of the Interior for Indian Affairs, testified for the Administration in support of the bill.

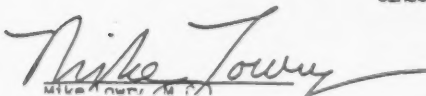
Since 1982, the Internal Revenue Service has sought to impose federal income taxes on Indians who exercise fishing rights reserved and protected by treaties that were signed between Pacific Northwest Tribes and the federal government in the 1850s. These fishermen have exercised these treaty rights under tribal regulation in areas reserved and protected by their treaty. The unprecedented action by the IRS violates these treaties.

Indian commercial fishermen who fish outside treaty-designated waters have always understood that they must pay the appropriate taxes on their non-treaty protected income. Such taxes are not now and never were in dispute. What is disputed is the IRS's attempt to materially diminish treaty-protected resources by imposing federal income tax on them.

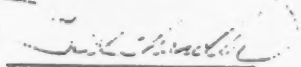
It is clear that Congressional action will be necessary to resolve this issue. Although IRS has agreed to withhold collection activities "for a reasonable period of time" while Congress considers legislation, the agency has continued litigation against Indian fishermen in U.S. Tax Court. We urge your prompt consideration of H.R. 2792 so that the long established meaning of Indian treaties will be clear.

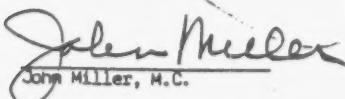
We look forward to hearing from you on this vital matter. If any of us can provide you with additional information, please do not hesitate to contact us.

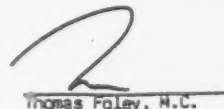
Sincerely,

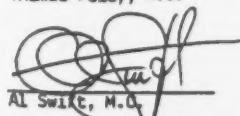

Mike Lowry, M.C.

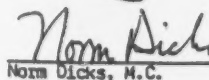

Ed Morrison, M.C.

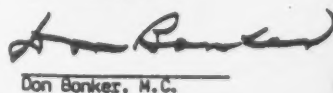

Rod Chandler, M.C.


John Miller, M.C.


Thomas Foley, M.C.


Al Swift, M.C.


Norm Dicks, M.C.


Don Bonker, M.C.

Mr. ANDREWS. Thank you, Mr. Frank.

Mr. James, do you have a statement or do you want to make a comment to the committee?

**STATEMENT OF JEWELL PRAYING WOLF JAMES, COORDINATOR,
LUMMI TREATY TASK FORCE, LUMMI INDIAN TRIBE**

Mr. JAMES. Yes, sir.

My name is Jewell James. I am with the Lummi Indian Tribe. I am the coordinator for the Treaty Protection Task Force. I am also coordinator for the Treaty Tribes of the Pacific Northwest, which we organized through several meetings on the Tulalip Indian Reservation.

Some history, the Lummi Indian Tribe is a party to a treaty between the United States and several other tribes in the Pacific Northwest. I would like to point out that prior to the 1850's, before the United States annexed the Pacific Northwest, when it was still disputing as to who had jurisdiction in regards to that territory, our tribes in the Pacific Northwest had established trade relationships with France, Spain, England, and Russia.

Under the 1787 ordinance, and this is the bicentennial celebration of it, and it is recognized as being celebrated by the President, the United States committed to honor the ownership of land and resources by the aboriginal governments, the Indian people, the tribes. As a result of that policy and as they expanded into the Northwest, the United States did enter into negotiations and treaties with the Indian tribes.

During treaty negotiations, and just preceding the treaty negotiations, our tribes had and were major figures in the delivery of fish products, seafoods and other things, to the new citizens that were coming into the Pacific Northwest.

Part of the negotiations did target specifically on reserving not only the salmon resources, the fish resources, resources that we had been dependent on for untold centuries and generations, but it specifically also reserved the commercial value.

This was recognized in a case referenced as *Fishing Vessel*, 1979, where in the U.S. Supreme Court specifically pointed out, from testimony and in evidence, that the Indian tribes in the Pacific Northwest had reserved the commercial value of these fish resources.

In 1974, in a case *United States v. Washington*, of which Mr. Morrisette is one of the attorneys that was very involved in that litigation, it pointed out that the fishing rights was reserved under the concept of "in common." In common was interpreted to mean that half would go to the Indians and half would go to the United States for their citizens.

So the United States does already have half of our resources, in regards to the fishing resources and shellfish resources. We believe our taxes, if any, have been paid already. They have been paid permanently.

When the case, *Earl v. Commissioner*, 1982, was decided, we were quite shocked that after 120 some years, a tax was going to be applied to the income from harvesting treaty resources or actually exercising our treaty rights.

It is not something that we can say is unexpected. My great grandfather on my mother's side and my great grandfather on my father's side were both involved in working toward protecting Indian fishing rights in the Pacific Northwest. We have always been confronted with litigation and legislation, trying to protect that which we reserved for not only ourselves, presently, but all future generations.

It is a mainstay of the Indian economy and the Indian culture in the Pacific Northwest. It is reflected not only in our ceremonies, but is a reflection of who we are as a people in the Northwest.

We hope that the subcommittee and the full committee would look at the testimony that we have submitted, both orally and in written form and recognize and support the concept that we believe, and we hope it becomes the statement of the committee that it is not now, and never was, the intent of the U.S. Congress to apply the Federal tax laws, and more specifically the income tax laws, to the income derived from harvesting treaty protected resources or resources either set aside by Executive order or other federal legislation.

That about, I think, summarizes it in five minutes and I would be happy to answer any questions when they come up.

[The statement of Mr. James follows:]



LUMMI INDIAN BUSINESS COUNCIL

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STATEMENT OF THE LUMMI INDIAN TRIBE BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES, HOUSE WAYS AND MEANS COMMITTEE, SUBMITTED BY JEWELL P.W. JAMES, COORDINATOR OF THE LUMMI TREATY PROTECTION TASK FORCE, HEARING ON H.R. 2792 ON 14 DECEMBER, 1987

The Lummi Indian Nation understands that the purpose of H.R. 2792 is to clarify that it is not now and never has been the intention of the U.S. Congress assembled that the federal tax laws, more specifically the federal income tax laws, were ever to be applied to the income of Tribal governments, and their membership, derived from the harvest of resources reserved by and protected under treaty or agreement between the Tribes and the United States, or set aside for the benefit of the Indians by federal enactments or Executive Orders. It is the understanding of the Lummi Nation that H.R. 2792 shall retroactively clarify this matter for the IRS, and its employees, once and for all.

The Congressional Budget Office has determined that enactment of H.R. 2792 would not result in a significant loss of federal tax revenue. Data generated by the Lummi Tribe in a 1981 commercial fishing loan study reveals that, based on generous estimates, the potential tax revenue which could be derived from all Lummi Tribal fishers, in an above average fishing year, would approximate \$70,000. Since the Lummi Tribe harvests approximately one-half of the total Stevens Treaty Tribal catch each year, the potential revenue which would be derived from taxing all income associated with the exercise of federally secured Indian Fishing Rights for all Tribes would probably not exceed \$120,000 annually.

According to Lummi Tribal Attorney Dan Raas, "if the United States was to absolutely tax all treaty Indian fish income this new year, all Tribes included, it could expect to maybe collect \$100,000 total. In addition to the low benefits of applying the tax, there would be substantial compliance problems, problems of a magnitude that far outweigh the collection efforts. You must keep in mind that the Lummis have already burned a couple fishing boats and more would probably burn if treaty fishermen lose and the tax is imposed." And, the Interior Department has pointed out that while the Seattle District Office of the IRS estimates that it has only spent about \$20,000 in staff time to bring forth the recent string of cases, that the actual costs of litigation support and attorney fees may run into the millions of dollars.

The Lummi Tribal Leadership is greatly concerned with this conflict. The Lummi People, like Indians on other reservations, are plagued by the highest infant mortality, shortest life-expectancy, lowest educational attainment or vocational training, highest poverty, highest unemployment/underemployment, and surrounded with extreme levels of ethno/racial bias amongst the general "dominant" society. We have spent several decades of struggle to receive and keep that which treaties guaranteed would be protected from encroachment of the citizens and governments; and, now, the IRS wants to add taxation of the treaty rights on top of the whole heap.

December 14, 1987

HISTORY OF THE PROBLEM AND THE LEGISLATIVE SOLUTION.

In 1982, the Internal Revenue Service (hereafter, IRS) began to implement plans to apply the federal income tax to Treaty Indians. The IRS Counselors planned using as precedence a case they brought against one individual, and then applying that victory to Treaty Fishermen in general, excluding the interest of the Tribes. This test case was *Earl v. Commissioner*, 78 T.C. 1014 (1982). This case came under the shadow of seven Supreme Court interpretations defining the treaty entitlement of the Indians. *United States v. Winans*, 198 U.S. 371 (1905); *Seufert Bros. Co. v. United States*, 249 U.S. 194 (1919); *Tulee v. Washington*, 315 U.S. 681 (1942); *Puyallup Tribe v. Department of Game (Puyallup I)*, 391 U.S. 392 (1968); *Department of Game v. Puyallup Tribe (Puyallup II)*, 414 U.S. 44 (1973); *Puyallup Tribe v. Department of Game (Puyallup III)*, 43 U.S. 165 (1977); *Washington v. Washington State Commercial Passenger Fishing Vessel Ass'n (Fishing Vessel)*, 443 U.S. 658 (1979).

The Lummi Tribe contends that fishing resources are targeted as a result of careful and deliberate planning by individuals within the IRS. The IRS, carefully selected a case that would, in their opinion, guarantee a victory in the Courts. The IRS identified a man fishing as an employee on a non-Indian fishing boat. This individual, Roy Earl, was not a registered member of the Puyallup Tribe at the time. In addition, Earl did not have services of an attorney. The Tax Court ruled that "Treaty Indians" must pay taxes, even though the question of "treaty status" of the resources harvested was not properly before the Court. The IRS attorneys secured a cheap victory with immeasurable implications in the U.S. Tax Court, unopposed by a reasonable defense for American Indians.

The essential reasoning of the U.S. Tax Court is that tax exemption status must be derived from some particular language in a treaty or statute that could imply the exemption. The Courts have held that the tax exemption cannot be based on policy alone or generalized references to treaties or statutes. The catch-22 is that the Constitution specifically spelled out "Indians not taxed." But, because such language is excluded as a defense, the Indians must attempt to find words in treaties or statutes that would imply the exemption that was previously the accepted standard of the day. Had the U.S. Constitution not been so specific as to the political exemption of the Indians from taxation, then it would most certainly be probable that treaties and statutes would have plainly included exemption language.

The Earl precedence was coordinated shortly after the Supreme Court decision in "Fishing Vessel." The IRS began to target the commercial value of the treaty fishing rights. In "Fishing Vessel" it was determined that the fishing rights reserved by the Indians in the treaties included not only the right to fish for subsistence purposes, but the right to fish for commercial purposes. This was recognized by the Supreme Court, as it quoted the District Court:

"At the time of the treaties, trade was carried on among the Indian groups throughout a wide geographic area. Fish was a basic element of the trade. There is some evidence that the volume of this intra-tribal trade was substantial, but it is not possible to compare it with the volume of present day commercial trading in salmon. Such trading was, however, important to the Indians at the time of the treaties. In addition...., there was considerable amount of outright sale and trade beyond the local community and sometimes over great distances. In the decade immediately preceding the treaties, Indian fishing increased in order to accommodate increased demand for local non-Indian consumption and for export, as well as to provide money for purchase of introduced commodities and to obtain substitute non-Indian goods for native products which were no longer available because of the non-Indian movement into the areas. Those involved in negotiating

LUMMI TESTIMONY

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December 14, 1987

the treaties recognized the contribution that Indian fishermen made to the territorial economy because Indians caught most of the non-Indians fish for them, plus clams and oysters." 443 U.S. at 665-666.

According to Interior Secretary Don Hodel: "The Stevens' Treaties have been interpreted by the Supreme Court to reserve to the Indians the rights to fish commercially, limited only to the extent that non-Indians must also be afforded the opportunity to fish and that Indian Treaty fishing may be regulated by the States (or the Federal Government) for resource conservation purposes. Indians who were parties to the Stevens' treaties understood that they would be able to continue fishing and trading fish without in any way having to turn over to the Federal government a portion of their catch. Diminution of the treaty fishing rights through the imposition of a tax not only represents an attack on the unique relationship existing between the United States and Steven's Treaty Tribes, but marks an abrupt departure from President Reagan's January 24, 1983, Indian Policy Statement which reaffirms the Federal government's responsibility involving Indian natural resources and which further encourages the development of strong reservation economies." (Hodel 3/22/85 letter to Attorney General Meese)

Several Treaty Tribes in the Pacific Northwest immediately sought to resolve this question on the taxable status of the treaty fishermen's income through the National Office Technical Advice Memorandum (NOTAM) process. The tribes wanted to exhaust administrative remedies, challenging the new theory of the IRS. The NOTAM process only resulted in conflicting inter-departmental opinions being issued by the "tax experts" versus the "Indian experts;" with the Department of Treasury (1983) versus the Department of Interior (1983 & 1985), with Department of Justice siding with Treasury, 1985.

In 1986, the conflict of the Lummi Indians was brought to the attention of Senator Bill Bradley. He was joined by Senator Dan Evans in the introduction and Senate passage of an amendment to the Debt Ceiling Bill of 1986, in attempt to resolve this inter-departmental federal dispute. The amendment was stripped off of the "Christmas Tree," or H.J. Res 668, as being not relevant under House Rules.

On March 12, 1987, the Indian Fishing Rights Bill was introduced to the U.S. Senate by Senators Evans (R-WA), Adams (D-WA), Bradley (D-NJ), Inouye (D-HA), McCain (R-AZ), and DeConcini (D-AZ). This bill, like the amendment, sought to reaffirm the tax-exempt status of these Treaty resources. A hearing was held, the measure was reported by the Senate Select Committee on Indian Affairs, then passed by unanimous consent of the U.S. Senate. And, in preparation of the Senate Hearing on S. 727, Assistant Secretary Ross Swimmer approached the Office of Management and Budget. He specifically requested that the Department of Interior be the Administration's witness at the hearing(s). The Office of Management and Budget agreed. The Department of Justice withdrew in a letter of acknowledgement to The Committee. Since then, Assistant Secretary Swimmer testified at the S. 727 Senate hearings on March 27, and Part I Hearings on H.R. 2792 of the House Interior and Insular Affairs Committee, on the 21st of July 1987.

Originally, Senate Bill 727 was sent over to the House Parliamentarian for referral to the appropriate Committees. The House Ways & Means Committee presented to the House Parliamentarian that S. 727 was unconstitutional; because it did not originate with the House. It appeared this bill was untimely sent over when the celebration of the Great Compromise of 1787 was scheduled. Thus, in compliance with the Great Compromise, Representatives Lowry of Washington, Chandler of Washington, DeFazio, Miller of California, Miller of Washington, Morrison of Washington, Mr. Sikorsky introduced H.R. 2792.

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CONCERNS OF THE TREATY TRIBES - A NATIONWIDE SENTIMENT.

Joseph DeLaCruz, President of the Quinault Indian Nation, whose fishing rights are also vulnerable to the IRS action, asserts that this attack on Indian resources by the IRS "constitutes a direct violation of the Treaties between the United States and the American Indian Governments." The other Indian Governments in the United States have joined in opposing this encroachment into the sphere of Indian sovereignty. Each of our Tribal governments stand prepared to both defend and protect the individual rights of our Tribal membership. The infringement by the IRS upon the Treaty-protected rights of our People is a direct assault on our rights.

Jeannette Wolfley, of the Native American Rights Fund, has sent correspondence in support of the Treaty Task Force, explaining that: "We represent several members of Indian Tribes in Michigan in opposing current efforts by the IRS to impose Federal taxes derived from Treaty-protected commercial fishing activities. This unwarranted, unprecedented attack on Indian Treaty resources has been opposed by two separate Interior Department Solicitors over the past six years and by strongly worded statements from Interior Secretary Hodel."

National Indian leaders are, of course, concerned that this issue will expose Indian Country to the last great United States rip-off of the American Indians. They believe this "case against the Lummi," as the IRS puts it, will have a domino effect and result in yet another grand-scale theft perpetrated by IRS agents and disguised as justice in the Tax Courts. The Task Force has received support from Tribes and inter-Tribal organizations across the United States. As their written comments and resolutions make clear, the Tribes are well aware of both the motive and consequences of the actions of the IRS and view both as unacceptable given the understanding expressed in the Treaties.

In this statement 1983, President Reagan's Indian Policy Statement was made public. In it was the concept of maintaining a "government-to-government relationship" between the United States and the (Lummi) Indian Tribe(s), as follows:

"When European colonial powers began to explore and colonize this land, they entered into Treaties with sovereign Indian Nations. Our new Nation continued to make Treaties and to deal with Indian Tribes on a government-to-government basis. Throughout our history, despite periods of conflict and shifting national policies in Indian Affairs, the government-to-government relationship between the United States and Indian Tribes has endured. The Constitution, the Treaties, laws, and Court decisions have consistently recognized a unique political relationship between Indian Tribes and the United States which this Administration pledges to uphold."

The IRS is implementing an agenda that includes taxing all treaty rights that guarantee to the American Indian people their control and enjoyment of land/natural resources reserved by treaty commitment. But, IRS career officials and staff counsels are developing new policy on Indian Country. Such agendas are contrary to the President's 1983 Indian Policy. However, the reason such career personalities are able to implement their own agendas was typified by President Harry S. Truman, in 1948, as follows:

"The difficulty with many career officials in the government is that they regard themselves as the men who really make policy and run the government. They look upon elected officials as just temporary occupants. Every President in our history has been faced with this problem: how to prevent career men from circumventing Presidential policy. Too often career men seek to impose their own views instead of carrying out the established policy of the Administration. Sometimes they achieve this by influencing the key men appointed by the President to put his policies into operation..."

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We can see that the career officials of the IRS have been able to exercise this very type of influence over the President's men. In this case, the Secretary of Treasury and the Attorney General both signed off on the IRS agenda. Both have signed onto legal opinions that hold that to apply the taxes is the "sounder view of the law." Even though the President has declared that it is his policy to NOT ABROGATE TREATIES MADE WITH THE INDIAN TRIBES, and even though the U.S. Constitution makes treaties the supreme law of the land, and even though the U.S. Constitution still provides "excluding Indians not tax," the IRS was able to convince appointees that the IRS agenda was a valid one.

As to another branch of the Federal Government, it is often said that the U.S. Court System is the greatest protector of the rights of Indian Nations, and that we should feel secure in this knowledge. Unfortunately, Indian Nations cannot take comfort from this widely proclaimed view. Since the U.S. Supreme Court reviewed the case of *Cherokee vs. Georgia*, it has been apparent that U.S. Domestic Courts are not legally competent to consider issues of dispute involving questions of the political sovereignty and jurisdictional powers of Indian Nations. When the Courts have considered such issues in connection with Indian Nations, they have more often than not taken positions which permitted the U.S. Government to undermine Tribal Sovereignty and erode the jurisdictional powers of Indian Governments.

While in *Worcester v. Georgia*, 30 U.S. (6 Pet.) 515, 557 (1832), the Court stated that "The treaties and laws of the United States contemplate the Indian territory as completely separated from that of the States," the Court in *Cherokee Nation v. Georgia* had superimposed a new view of the federal/Indian relationship. A view not contemplated in the original understanding underlining the agreements between the Indian Nations and the United States. Wherein, the Court found that the Indians are "in a state of pupilage; their relation to the United States resembl[ing] that of a ward to his guardian. They look to our government for protection; rely upon its kindness and its power; appeal to it for relief to their wants; and address the President as their father. 30 U.S. (5 Pet) 1,17 (1831). And, now, with the IRS acting as an arm of the "father," the "guardian," it has become a state wherein the guardian taxes the ward to "benefit" the guardian. Under this scenario, the concept of "guardianship" more closely resembles the "abused child syndrome." In this analogy, each time the tribes and their people (the Wards), attempt to stand on their own (socio-economic & political) feet another arm (IRS) of the federalist father (U.S.A.) strikes them down (external taxation drains reservation economies of revenues.)

Indian Tribes, nationwide, have been watching the recent confrontations between the Federal Government (IRS) and Lummi "Indians not taxed." This issue is not new to the United States of America. The definition quoted was developed by the Founding Fathers of the Constitution, and retained through the Reconstruction Debates. Ever since the enactment of the 1924 Indian Citizenship Act, Court room battles have been waged against Indian Country..." Indians not taxed."

While America at-large may be insensitive to this shift in federal/Indian relationships, the international community is not. A petition from the Parliament of Europe was circulated and signed by over 20 Parliamentarians. The petition demands the United States honor its Treaty relationship with the American Indian. Other international organizations, such as INCOMINDIOS, The World Council of Indigenous Peoples, and The World Council of Churches have echoed the demands of the European Parliament. Even in Nations as far away as South Africa, leaders such as Bishop Tutu and Chief Buthelezi have indicated support for the position of the Treaty Task Force.

THE U.S. CONSTITUTION IS NOT AN AFFIRMATIVE DEFENSE?

Because Indians were not subject to the complete jurisdiction of the United States, the United States negotiated treaties with the Tribes. The Treaties were meant to keep their people separate from ours, and to divide territory and maintain boundaries. The framers of the Constitution intended that the United States and Indians would remain separate. Article 1, section 2, clause 3, excludes Indians from citizenship by the words "excluding Indians not taxed." This clause was reiterated in section 2 of the Civil Rights Act of 1866. It was kept in the 14th Amendment in Section 2. And, the words "subject to the jurisdiction thereof" in section 1 of the 14th Amendment meant that Indians could not be citizens because they were not totally and completely subject to the jurisdiction of the United States. Section 1 applied to anywhere in the jurisdiction of the United States, and section 2 applied within any States. While it is noted that individual Indians could cut their ties with their Tribes and leave Indian country reservations and become a citizen - if one subjects himself to the complete jurisdiction of the United States and gives up allegiance to the tribe, then he qualifies to become a U.S. citizen. Neither the States or the Federal Government viewed the Indians as citizens or within their taxing power, originally. It was the intention of more than 350 treaties made between the Indians and the United States government to keep each others people and territories separate.

The conditions of these Indians as a people separate from the Community of people of the United States had not changed by the time of the adoption of the Fourteenth Amendment. Their exemption from the application of State laws had been affirmed by the Supreme Court on more than one occasion. (*Worcester v. Georgia*, 6 Pet. 515) The same session of the Congress which approved the Fourteenth Amendment, and which submitted it to the States for adoption, passed the Civil Rights Bill of 1866 (14 Stat. 27). It provided that "all persons born in the United States and not subject to any foreign power, excluding Indians not taxed, are hereby declared to be citizens of the United States."

The IRS argues that the 1924 Citizenship Act authorizes taxing jurisdiction. If this is true, then this Act does so very ambiguously. In most cases of legislation, the act must be specific and clear and not ambiguously worded. But, in accordance to the IRS - as supported by the Department of Justice - this is not so. In "Indian law," the Courts usually require showing that the intent to apply the law to Indian Country was clearly intended by the Congress. But, in the Tax Courts this is not the rule. The Tax Court and its "court officials" - the IRS Attorneys - will continue to apply taxing authority to Indian Country on a case by case basis, each being a part of the cumulative problem. Until the Tribal Governments are able to force review of the constitutionality of the "excluding Indians not taxed" words and intent, under valid canons of construction and interpretation of constitutions, the Tax Court shall continue to follow precedence established.

The leading tax case cited by the IRS is that of *Squire v. Capoeman*, 351 U.S. 1 (1956), in which the Supreme Court considered whether capital gains from the sale of standing timber on lands allotted to noncompetent Indians was subject to the federal income tax. The Court began its analysis in *Squire* with the principle that: "Indians are citizens and...in ordinary affairs in life, not governed by treaties or remedial legislation, they are subject to the payment of income taxes as are other citizens." This leading case was used against the treaty fishermen to allegedly prove there was not a treaty exemption for Treaty Income. In *Earl v. Commissioner*, 78 T.C. 1014 (1982) it was put forth that "treaty Indians" are "citizens" and all citizens pay taxes; therefore, Indians will have to pay federal income taxes on treaty derived income. Even more ironic is the fact that *Squire* is used to teach Indian Country the type of legislative language the IRS believes is needed to provide exemption, when in fact the General Allotment

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Act (central and indispensable to Squire analysis) was used as justification to take 90 million treaty-protected acres, in violation of the supremacy clause of the Constitution.

The legal cornerstone of the IRS's arguments is the "citizenship" question. Citizenship has effectively eliminated the ability of the Indian to use the constitutional wording as a defense in Tax Court. But, the original wording of the U.S. Constitution defines those Indians in tribal relations as "Indians not taxed." Under the original intent, Indians, members of sovereign and separate communities or Tribes, were outside of the community of people of the United States even though they might be located within the geographical boundaries of a State. Their status was well described by Chancellor Kent when in 1823 he said: "Though born within our territorial limits, the Indians are considered as born under the dominion of their tribes. They are not our subjects, born within the purviews of the law, because they are not born in obedience to us. They belong, by birth, to their own Tribes, and these Tribes are placed under our protection and dependent upon us; but still we recognize them as national communities..." (Goodall v. Jackson, 20 Johns. 693, 711)

To describe these Indians who were not a part of the community of people of the United States the phrase "Indians not taxed" was chosen. The reasons for the choice of the particular phrase was easily surmised. It reflected, first, the prevalent notion that taxation and representation should go hand in hand. It reflected, secondly, the fact that in a less complex system of government, taxation is the principle criterion of government authority. No more significant attribute of the condition of the Indian living in his separate and independent community should have been chosen. Being outside the control of either State or Federal Government, he was an "Indian not taxed," and since he did not bear the financial burden of the government, he was not entitled to representation therein." (United States v. Kagam, 119 U.S. 375, 378)

In the case of Elk v. Wilkins, 112 U.S. 94, John Elk, an Indian who had claimed to have permanently severed his ties with his Tribe, and had taken up residence among the whites, asserted that he was denied his right to vote on the ground that he was not a citizen. The Supreme Court considered the question as to whether or not he was covered by the first clause of the first section of the Fourteenth Amendment of the United States Constitution, by which it is provided, "all persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and the State wherein they reside."

The Supreme Court held that: "Indians born within the territorial limits of the United States, member of, and owing immediate allegiance to, one of the Indian Tribes (an alien, though dependent, power), although in a geographical sense born in the United States, are no more "born in the United States and subject to the jurisdiction thereof," within the meaning of the first section of the Fourteenth Amendment, than the children of subjects of any foreign government born with the domain of that government, or the children born within the United States, of ambassadors or other public ministers of foreign nations."

This view is confirmed by the second section of the Fourteenth Amendment, which provides that "representatives shall be apportioned among the several States according to their respective numbers, counting the whole number of persons in each State, excluding Indians not taxed." Slavery having been abolished, and the persons formerly held as slaves made citizens, this clause fixing the apportionment of representatives has abrogated so much of the corresponding clause of the original Constitution as counted only three-fifths of such persons. But Indians not taxed are still excluded from the count, for the reason that they are not citizens. Their absolute exclusion from the basis of representation, in which all other persons are now included, is wholly inconsistent with their being considered citizens. (112 U.S. Reports, 98-99, 102, 109)

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"In the (1866 Civil Rights) Bill, as originally reported from the Judiciary Committee, there were not words excluding "Indians not taxed" from the citizenship proposed to be granted. Attention being called to this point, the friends of the measure disclaimed any purpose to make citizens of those who were in tribal relations with governments of their own. In order to meet that objection, while conforming to the wishes of those desiring to invest with citizenship all Indians permanently separated from their Tribes, and who, by reason of their residence away from their Tribes, constituted a part of the people under the jurisdiction of the United States. Mr. Trumbull, who reported the bill, modified it by inserting the words, "excluding Indians not taxed." What was intended by that modification appears from following language used by him in debate."

"...Of course we cannot declare the wild Indians who do not recognize the Government of the United States at all, who are not subject to our laws, with who we make treaties, who have their own regulations, whom we do not pretend to interfere with or punish for the commission of crimes one upon the other, to be subjects of the United States in the sense of being citizens. They must be excepted. The Constitution of the United States excludes them from the enumeration of the population of the United States, when it says that Indians not taxed are to be excluded. It has occurred to me that perhaps an amendment would meet the views of all gentlemen, which used these constitutional words, and said that all persons born in the United States, "excluding Indians not taxed," and not subject to any foreign power, shall be deemed citizens of the United States." (Cong. Globe, 1st Sess., 39th Cong., p. 527)

It is not surprising to find the following statement in a report of the Judiciary Committee to the Senate of the United States on the 14th of December, 1870, in obedience to an instruction to inquire as to the effect of the Fourteenth Amendment upon the treaties which the United States had with various Indian Tribes of the Country:

"During the war slavery had been abolished, and the former slaves had become citizens of the United States; consequently, in determining the basis of representation in the Fourteenth Amendment, the clause 'three-fifths of all other persons' is wholly omitted; but the clause 'excluding Indians not taxed' is retained.

"The inference is irresistible that the amendment was intended to recognize the change in the status of the former slave which had been effected during the war, while it recognized no change in the status of the Indians. They were excluded by the original Constitution, and in the same terms are excluded by the amendment from the constituent body, the people." (Department of Interior Solicitors Opinion (November 7, 1940, p. 992)

During the reconstruction debates over the 14th Amendment, the Senate (39th Cong. 1st Sess. (May 29-30, 1866)) had addressed House Joint Resolution 127. This was the resolution that introduced the proposed language to be included in the first and second sections of the amendment. Members of the Senate debated whether or not the provisions of the 14th Amendment should be extended to the "Indians not taxed" or "wild Indians" or "Indians remaining in Tribal relations." The debate was on the issue as to whether or not the language "excluding Indians not taxed" should be in both sections of the amendment. However, what was not disputed was the fact that the "Indians" were not to be made "citizens of the United States of America."

"In the first section, it was provided, the Indians were excluded by the wording of subject to the jurisdiction thereof. Mr. Trumbull, Chairman of the Committee of the Judiciary, stated this point in the debate,..." (39th Cong. 1st Sess. (May 29-30, 1866)). Mr. Williams pointed out in the debate his observations,

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as follows: "I would not agree to this proposed constitutional amendment if I supposed it made Indians not taxed citizens of the United States. But I am satisfied that, giving to this full and fair and reasonable construction, it does not include Indians not taxed. The first and second sections of this proposed amendment are to be taken together, are to be construed together. And the meaning of the word "citizens" as employed in both sections, is to be determined from the manner in which that word is used in both of those sections. (39th Cong. 1st Sess. (May 29-30))

Mr. Howard, Senator from Michigan, stated that "...Certainly, Gentlemen cannot content that an Indian belonging to a tribe, although born within the limits of a State, is subject to this full and complete jurisdiction. That question has only since been adjudicated, so far as the usage of the Government is concerned. The Government of the United States have always regarded and treated the Indian Tribe within our limits as Foreign Powers, so far as the treaty-making power is concerned, and so far especially as the commercial power is concerned, for in the very Constitution itself there is a provision that Congress shall have power to regulate commerce, not only with Foreign Nations and among the States, but also with the Indian Tribes. That clause, in my judgment, presents a full and complete recognition of the national character of the Indian tribes, the same character in which they have been recognized ever since the discovery of the continent and its occupation by civilized men; the same light in the Indians they were viewed and treated by Great Britain from the earliest commencement of the settlement of the continent." (39th Cong. 1st Sess. (May 29-30))

"Now, can any reasonable man conclude that the word "citizens" there applies to Indians not taxed, or include Indians not taxed when they are expressly excluded from the basis of representation and cannot even be taken into the enumeration of persons upon whom representation is to be based? I think it is pretty clear, when you put the first and second sections together, that Indians not taxed are excluded from the term "citizens;" because it cannot be supposed for one moment that the term "citizens," as employed in these two sections, is intended to apply to Indians who are not even counted under any circumstances as a part of the basis of representation. I therefore think that the amendment of the Senator from Wisconsin is clearly unnecessary. I do not believe that Indians not taxed are included, and I understand that to be descriptive of Indians who maintain their tribal relations and who are not in all respects subject to the jurisdiction of the United States." (39th Cong. 1st Sess. (May 29-30))

In 1861, the first Federal income tax was authorized to be levied "upon the annual income of every person residing in the United States, ...derived...from any... source whatever." Act of August 5, 1861 (12 Stat. 292, 309). The tax was abolished in 1872" (Dewey Financial History of the United States, page 305). The special significance is that in no instance were any of these numerous taxes applied to Indians living in their separate tribal communities, even though, as in the case of the income tax, it was by its provisions intended to apply to "every person residing in the United States." The reason for the non-application of such a tax to Indians was the same as the reason for the non-application of all laws of general application to Indians. They were considered a people separate from the community of people of the United States; and thus, it was not to be inferred, in the absence of clear and unambiguous language to the contrary, that Congress intended to subject them to a law which by its terms applied to every person residing in the United States. *Elk v. Wilkins*, 112 U.S. 94.)

The U.S. Constitution has been amended many times, ratified by the required three-fourths of the States. Amendment Fourteen was specifically added to address the freed negro slaves, the Chinese, and immigrant people from "India." To prove that it is was not intended to be applied to the American aboriginal Indians, the

wording "excluding Indians not taxed" was retained in the second section of the amendment and clearly by the words "subject to the jurisdiction thereof" in the first section. It is significant to point out that the amendment process is applicable to Congress assembled and its dealings with American Indians.

This obligation is well versed by Justice Cooley, in his classic commentaries on the Constitution: "A cardinal rule in dealing with written instruments is that they are to receive an unvarying interpretation, and that their practical construction is not to be made to mean one thing at one time and another at some subsequent time when the circumstances may have changed as perhaps to make a different rule in the case seem desirable. A principle share of the benefit expected from written constitutions would be lost if the rules they established were so flexible as to bend to circumstances or be modified by public opinion... Public sentiment and action effect such changes, and the Courts recognize them; but a Court or legislature which should allow a change in public sentiment to influence it in giving to a written constitution a construction not warranted by the intention of its founders, would be justly chargeable with reckless disregard of official oath and public duty. The violence of public passion is quite as likely to be in the direction of oppression as in any other; and the necessity for bills of rights in our fundamental laws lies mainly in the danger that the legislature will be influenced, by temporary excitements and passions among the people themselves, to make such changes as new circumstances may require. The meaning of the Constitution is fixed when it is adopted, and it is not different at any subsequent time when a Court has occasion to pass upon it. The object of construction, as applied to a written Constitution, is to give effect to the intent of the people in adopting it." (Cooley's Constitutional Limitations, 68-69 (6th ed. 1890))

THE STATUTORY LANGUAGE INTENTION. The Lummi Tribe assumes that this legislation shall include that" (1) The term "Indian" includes a duly enrolled member of an Indian Tribe, and any corporation, partnership or other business entity one hundred percent (100%) owned by such Indian; (2) The legislation covers all fishing activity and the term "fishing activity" includes the rearing for harvest, the harvest or capture, by net, hook, spear, traps or weirs of fish, shellfish, and other marine species of faunal and floral life, including assisting another Indian in such activity, where such fishing activity takes place within historical fishing places of the tribe or within the exterior boundaries of a federally recognized Indian reservation or at usual and accustomed places within or without an Indian reservation. Fishing activity further includes buying, selling and reselling fish or fish products to a processor, warehouse, trader, exporter, retailer or ultimate consumer when such activity is undertaken by an Indian or Indian Tribe; (3) The terms "historical places" or "usual and accustomed places" includes all places, grounds, stations, sites and locations reserved, secured or retained to Indians by treaty, Executive Order or congressional act for the benefit of Indians; (4) The term "assisting" includes an Indian working as a crew member on a boat or vessel owned by an Indian or Indian Tribe, and an Indian working as an employee of an Indian or Indian Tribe when engaged in a fishing activity; (5) Finally, that this legislation is intended to retroactively apply in favor of the Individual Indians and Tribes.

Mr. ANDREWS. Thank you very much for your testimony. Mr. Jones, do you want to make a statement?

STATEMENT OF STANLEY G. JONES, SR., CHAIRMAN, TULALIP TRIBES OF WASHINGTON

Mr. JONES. Mr. Chairman, I am Stanley Jones, Sr., chairman of the board of directors of the Tulalip Tribes and yes, I would like to introduce a statement for the record, and I mailed one in last Friday.

I would like to read this, in the interest of time, and I will just summarize.

On behalf of the board of directors of the Tulalip Tribes, I would like to thank you and the committee for this opportunity to present the views of the Tulalip Tribes concerning H.R. 2792. This bill will clarify the tax status of income derived from the exercise of fishing rights secured by treaties and Executive orders.

We commend the sponsors for introducing this vital Indian measure and the committee for holding this hearing. H.R. 2792 will reaffirm the meaning and the intent of the treaties entered into between the Government of the United States and Washington Indian Tribes in 1855 and will confirm the Federal Government's trust responsibilities under those treaties.

The Tulalip Tribes recommend passage of H.R. 2792. Its enactment will stand as a clear signal to all that the United States honors its word.

Mr. Chairman, I would like to note in passing that last week President Reagan signed a treaty with the Soviet Union. Our treaties were not signed last week, but to us they are as fresh and binding as if they had been ratified this morning.

If, after all these years, the Internal Revenue Service, supported by the U.S. Department of Justice, can arbitrarily, retroactively and unilaterally reinterpret the intent of our treaty, what faith or security can any nation have in the solemn pledges of the United States.

Fishing is as important to us today as it was in 1855. Indeed, fishing continues to serve as the mainstay of our cultural and religious practices and our economy. When asked how many of our members are fishermen, we say that we are all fishermen.

I am a full-time fisherman myself and have been for some 40 years. Even for those of us who do not fish as the main source of their income, fishing serves as some part of their subsistence and as an important cultural and religious event.

On the Tulalip Reservation, and on other reservations throughout the Northwest, income from fishing often supports an extended family. Some members of a family will spend only part of their time fishing while others fish full-time, as I do. We encourage this because it continues our way of life and provides a means of livelihood free from government welfare programs.

President Reagan, in his Indian policy statement in 1983, stressed the importance of encouraging economic development and self-sufficiency. The most cost-effective job program to encourage economic self-sufficiency among our people is to sustain our treaty fishing rights free from Federal taxation.

Mr. Chairman, the United States assured the tribes that the treaties would secure their fishing rights. Governor Stevens, the chief negotiator for the United States, said "This paper secures your fish." And in fact, the fishery is the principal economic resource reserved under the treaties by western Washington tribes. The vital importance of the fishery has not diminished with time.

Historically, both the tribes and the United States have recognized that treaty fishing income is not subject to taxation. Until recently, the Internal Revenue Service did not apply the Federal income tax to treaty fishing income. We do not believe that Congress intended to abrogate any part of the treaties when it passed the Internal Revenue Code. If the IRS approach is adopted, all treaty rights and trust resources will be in danger.

I want to emphasize in closing that the Northwest Indian tribes paid a heavy price in the bargain they struck with the United States by giving up millions of acres of their traditional homelands. We believe the treaties secured our fishing rights for all time.

Congressman Udall's committee has favorably reported the bill. We urge this committee to move quickly for enactment of H.R. 2792 to uphold the word of the Federal Government in the treaties under consideration, as well as those affecting other tribes across the country.

Along with our written statement, we are submitting a legal memorandum extensively discussing the legislative history of this issue.

Thank you, Mr. Chairman and members of the committee.

[The statement of Mr. Jones and supplemental documents follow:]

STATEMENT OF STANLEY G. JONES, SR., CHAIRMAN
THE TULALIP TRIBES OF WASHINGTON
ON

H.R.2792

A BILL TO CLARIFY INDIAN TREATIES AND
EXECUTIVE ORDERS WITH RESPECT TO FISHING RIGHTS
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

DECEMBER 14, 1987

My name is Stanley G. Jones, Sr., I am Chairman of the Board of Directors of the Tulalip Tribes of Washington. On behalf of the Board, I would like to thank you and the Committee for this opportunity to present the views and recommendations of the Tulalip Tribes concerning H.R.2792, a bill to clarify the non-taxable status of income derived from the exercise of fishing rights secured by treaties and Executive Orders. We commend the co-sponsors for introducing this vital Indian measure and the Committee for holding this hearing.

In our view, this legislation will reaffirm the meaning and intent of the treaties entered into between the government of the United States and Washington Indian tribes in 1855 and will confirm the Federal Government's trust responsibilities under those treaties. The Tulalip Tribes recommend passage of H.R.2792. Its enactment will stand as a clear signal to all that the United States honors its word.

Mr. Chairman, I would like to note in passing that just last week President Reagan signed a treaty with the Soviet Union. Our treaties were not signed last week, but to us they are as fresh and binding as if they had been ratified this morning.

If after all these years the Internal Revenue Service, with the support of the United States Department of Justice, can arbitrarily, retroactively and unilaterally reinterpret the intent of our treaty, what faith or security can any nation have in the solemn pledges of the Federal Government?

The Tulalip Tribes of Washington are the descendants of several of the tribes and bands which signed the Treaty of Point Elliott on January 22, 1855. We have reserved treaty fishing rights under that Treaty. For centuries, fishing and hunting were central to the way of life of my ancestors. Fishing was the cultural, religious and economic mainstay of our people for centuries before the treaties. It served to give us a rich and varied life as well as a firm economic base.

We have already suffered great losses. In the treaties, we ceded large areas of land and agreed to a small reservation of 22,000 acres of land in return for our reserved fishing rights. The United States' promises that the treaties would protect that source of food and commerce in perpetuity were crucial in obtaining the tribes' agreement to the treaties. The negotiators for the United States recognized the importance of fishing to our economy, this point was stressed throughout the negotiations.

Today, with only approximately 8,000 acres left in tribal ownership to serve as a base from which to exercise our fishing rights, fishing continues as it did in treaty times to serve as the mainstay of our cultural and religious practices and our economy. When asked how many of our members are fishermen, we often say that we are all fishermen. Our children, as they grow up, learn to fish - much as we did, and, as our forefathers did.

Even for those who work at some other trade, fishing provides part of their subsistence and serves as an important cultural and religious event. For some, fishing is a part-time job. But fishing, even with more modern gear and methods, is a difficult activity. Those who make their living from fishing do so at a tremendous investment of time and effort and can ill afford to have this treaty right taxed. I speak from experience. I am a full-time fisherman and have been in the business some 40 years.

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Mr. Chairman, the United States assured the tribes that the treaties would "secure" their fishing rights. Governor Stevens, the chief negotiator for the United States, stated at the time, "This paper gives you a home.... This paper secures your fish." In fact, the fishery is the principal economic resource reserved under the treaties by Western Washington tribes. The vital economic importance of the fishery to us has not diminished with the passage of time.

On the Tulalip Reservation, and on other reservations throughout the Northwest, fishery income often supports an extended family. Brothers, sisters, cousins, nephews and nieces may spend some or all of their time engaged in fishing. We wish to encourage this since it continues our way of life and provides a means of livelihood free from government welfare programs.

Historically, both the tribes and the United States have recognized that treaty fishing income is not subject to taxation. In 1942, the Supreme Court of the United States agreed with us that a state cannot impose a charge upon the exercise of our fishing right and held that the treaty prohibited this. The same principle applies to the United States. The Solicitor of the Department of the Interior recently reaffirmed the long-accepted understanding that treaty fishing income is not subject to Federal taxation. Indeed, until its recent policy reversal, the Internal Revenue Service historically did not apply the Federal income tax to treaty fishing income.

Frankly, we were caught by surprise when the IRS began to try to collect tax on our income from treaty fishing. Our ancestors helped the United States achieve peace in the Northwest Territory during treaty times. The United States made a bargain with us. The action of the IRS makes us feel a deep sense of betrayal. We have always believed, and continue to believe, that the United States Government acted in good faith when it promised our forefathers that the fishing rights would not be impaired in any way.

Let me say here that as co-managers of the fishery we are acutely aware of and believe in the necessity of assuring conservation of the resource. We also believe, and H.R.2792 will reaffirm, that Congress did not intend to abrogate any part of the treaties when it passed the Internal Revenue Code.

In our opinion, the honor of the Nation is involved in this issue. We urge that the Internal Revenue Service's approach to dealing with treaty commitments and trust responsibilities be strongly rejected. All Federal agencies, including the Internal Revenue Service, share the Federal trust responsibility to protect the tribes' treaty fishing rights. If the approach of the IRS in this matter is adopted, all treaty rights and trust resources will be in danger.

Speaking of the Federal trust responsibility, let me point out that over the past years we have seen many government welfare and jobs programs come and go. The most cost-effective job program to encourage economic self-sufficiency among our people is to sustain our treaty fishing right free from government taxation. President Reagan in his Indian Policy Statement of January 24, 1983, highlighted the importance of economic development and self-sufficiency and mentioned fishing as an avenue to tribal economic development.

The Internal Revenue Service and the Justice Department seem to have placed themselves over and above the stated policy of the President. A Federal income tax on our fishery income would drive some of us out of business. Many of our members currently pay a tribal tax on their earnings from fishing activities and imposition of a Federal income tax on those same activities would greatly impair our ability as a tribal government to impose and collect a tribal tax which is an important source of income to our tribal governments. This income goes to support search and rescue, marina maintenance, fisheries patrol and fisheries enhancement.

The Tribes would like to see the legislative history of H.R.2792 include ample discussion on the scope of fishing activities protected from federal taxation by the treaties. For the Committee's convenience, a legal memorandum dealing extensively with this issue is attached.

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Mr. Chairman, I want to emphasize in closing that Northwest Indian tribes paid a heavy price in the bargain they struck with the Federal Government by giving up millions of acres of their traditional homelands. Our forefathers believed the treaties secured our fishing rights for all time. We modern-day leaders share that belief as well. But now the IRS in concert with the Justice Department seeks to rewrite history and reinterpret the treaties by declaring the treaty right to be fair game for a Federal tax. The House Committee on Interior and Insular Affairs chaired by Congressman Udall has reported this measure favorably. We urge this Committee to move quickly for enactment of H.R.2792 to uphold the integrity and word of the Federal Government in the treaties under consideration here as well as those affecting other tribes across the country.

Thank you.

TULALIP TRIBE'S SUPPLEMENTAL LEGAL MEMORANDUM IN SUPPORT OF
HR 2792

A BILL TO CLARIFY INDIAN TREATIES AND
EXECUTIVE ORDERS WITH RESPECT TO FISHING RIGHTS
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

I.

INTRODUCTION

This Supplemental Legal Memorandum is submitted on behalf of the Tulalip Tribes of Washington in support of HR 2792, a Bill which would clarify the non-taxable status of income derived by Indians from the exercise of treaty rights secured by treaties and executive orders. Stanley G. Jones, Sr., Chairman of the Tulalip Tribes, testified before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, United States House of Representatives, at its December 14, 1987 hearings on HR 2792 and submitted a written statement for the hearing record. The Tulalip Tribes also submitted a Legal Memorandum supplementing that testimony and statement ("Tulalip Legal Memorandum").

This Supplemental Legal Memorandum is intended to respond to certain concerns presented by the statement of C. Eugene Steuerle, Deputy Assistant Secretary (Tax Analysis), Department of the Treasury (hereinafter "Treasury Testimony") which was also presented at the December 14, 1987 hearing.

II.

THE TREASURY TESTIMONY ERRONEOUSLY DESCRIBES PRESENT LAW

The Treasury Testimony portrays two tax court decisions (Earl v. Commissioner, 78 T.C. 1014 (1982); and Strom v. Commissioner, 6 T.C. 621 (1946), aff'd. per curiam, 158 F. 2d 520 (C.A. 9, 1947)) as the "present law" concerning taxability of the treaty fishing income in question. Such portrayal is erroneous and incorrectly implies that HR 2792 would change present law.

In fact, the purpose of HR 2792 is to clarify the non-taxable status of such fishing income under existing law. The two opinions of the Solicitor of the Department of Interior which were filed with the Tulalip Legal Memorandum accurately characterize existing law which requires the conclusion that such fishing income is non-taxable. This conclusion is based upon United States Supreme Court decisions construing and interpreting the treaties in question, and applying canons of treaty construction which are well settled. These decisions post-dated Strom, and their principles and holdings were not considered or applied by the tax court in Strom and cannot be reconciled with Strom's result. The Ninth Circuit's per curiam affirmation of Strom does not reflect any significant independent analysis indicating consideration of the proper construction of the treaties, in light of applicable canons of treaty construction.

The tax court in Strom reasoned that the commercial fishery from which Mr. Strom derived his fishing income was not part of the reserved treaty fishing right and therefore was taxable:

"Likewise we do not agree with the position of petitioners that in the making of the treaty the understanding of the Indians of its terms that the Government was precluded from laying any such burden [income tax] upon him. It is far cry from the fishing operations of the members of an uncivilized tribe of Indians at the time of the execution of this treaty and the commercial fishing business now carried on by these petitioners. Of course, there is nothing to indicate that when the Quinalt Treaty was executed that such taxes as are here involved had even been conceived. The parties to that treaty, certainly, did not contemplate the present situation."

6 T.C. at 627-8. This reasoning ignores the basic canon of treaty construction that treaties are to be interpreted as the Indians understood them. See Tulalip Legal Memorandum at 3-5; Washington v. Fishing Vessel Ass'n., 443 U.S. 658, 675-676 (1979) ("Fishing Vessel"). In this regard, it is noteworthy that the Treasury testimony concedes that:

"The Indians who were parties to the treaties understood that they would be asked to fish (and trade fish) on the same basis as they had before the signing of the treaties, when they neither were required to pay taxes nor to turn over any portion of their catch to the federal government. H.R. 2792 would embody this understanding...."

The Tax Court's conclusion in Strom that commercial fishing was not part of the reserved treaty fishing right and therefore was taxable is incorrect. In Fishing Vessel, the Supreme Court made clear that the treaty reserved to the Indians their thriving commercial fishery, a commercial fishery that included trade not only with other Indians, but also with the non-Indian settlers in the area. 443 U.S. at 665-666 and fn 7 and 8.

In light of these serious errors in Strom's reasoning, it simply cannot be regarded as persuasive precedent.

Earl is also not persuasive precedent because it is based upon Strom.

Additionally, Earl lacks persuasiveness because of its factual deficiencies. The Earl case did not involve treaty fishing income. Instead, the case involved the Puyallup Indian employed on a non-Indian boat as a cook. The boat was not fishing in treaty waters and, thus, even if the taxpayer Indian had been fishing, such fishing would not constitute the exercise of a treaty right. Nonetheless, the IRS obtained a stipulation from the taxpayer that the income in question was derived from treaty fishing. Given these factual deficiencies, Earl cannot properly be regarded as a treaty fishing income case.

Further, Earl lacks persuasiveness because the lay taxpayer in Earl was not represented by counsel and did a very poor job in presenting and advocating the proper construction of the treaty required by post-Strom Supreme Court case law construing the treaties, and applying applicable canons of treaty construction, as set forth in the above-referenced Department of the Interior Solicitor's opinions which were filed with the Tulalip Legal Memorandum.

Based upon the foregoing the Tulalip Tribes respectfully submit that Strom and Earl cannot properly be characterized as existing law. They are simply not persuasive precedent and the more recent Supreme Court treaty decisions discussed in the Solicitor's opinions and the Tulalip Legal Statement cannot be reconciled with their result.

Nonetheless, HR 2792 is needed to clarify existing law because the Internal Revenue Service continues to rely upon Strom and Earl as a basis for seeking to tax the treaty fishing income in question, despite the fact that the administration supports HR 2792.

III.

EFFECT OF HR 2792 ON PENDING TREATY FISHING INCOME CASES

With respect to the concern expressed in the Treasury Testimony regarding the effect of HR 2792 on pending treaty fishing income cases, the Tulalip Tribes believe that since the purpose of HR 2792 is to clarify existing law, its provisions must necessarily apply retroactively, and HR 2792 should therefore require disposition of those pending cases in favor of the Indian taxpayers. The Tribe requests that the legislative history on HR 2792 clearly so indicate.

IV.

FICA AND FUTA CONCERNS

The Tulalip Tribes believe that the same reasoning which precludes federal income taxation of income derived from the exercise of fishing rights under treaties and executive orders also precludes the application of FICA and FUTA taxes to such income. It is the treaty tribes understanding that treaty fishing income is not subject to taxation in any form.

However, the Tulalip Tribes believe that an amendment to HR 2792 to expressly addresses the non-applicability of FICA and FUTA taxes to treaty fishing income is unnecessary, and that a short discussion in the legislative history so indicating will suffice.

With respect to the concern of the Treasury testimony that any exemption from FICA and FUTA not work to the detriment of the affected persons, the Tulalip Tribes wish to point out that the vast majority of treaty fishermen are also employed in other jobs subject to such taxes and thus are eligible to participate in the resulting benefits. In any event, the protection of the full treaty benefits bargained for by the Tribes from intrusion or

diminishment by taxation in any form is of overriding importance to the treaty tribes.

V.

POTENTIALLY BURDENSOME ALLOCATIONS

With respect to the Treasury testimony's concerns that HR 2792 may require potentially burdensome allocations between fishing and non-fishing income in order to determine what income remains fully taxable, the Tulalip Tribes note that the need to make such an allocation should present no difficulties since treaty fishing income is derived from the specific activity of fishing in tribal usual and accustomed areas during specified times of the year when fishing is allowed, thus enabling fishermen to keep records discrete to that activity. Moreover, allocations of income between fishing and non-fishing activities should be no more difficult than allocations made by any individual operating two businesses and reporting their respective incomes separately.

VI.

CONCLUSION

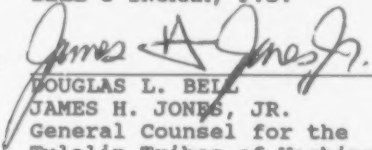
The Tulalip Tribes welcomes the support of the Treasury Department of HR 2792 but believes that the Treasury Testimony incorrectly portrays HR 2792 as a change, rather than a clarification, of existing law and further believes that the concerns of the Treasury Department discussed above can be adequately addressed in the Bill's legislative history, and that an amendment to the text of HR 2792 is unnecessary.

DATED this 22nd day of December, 1987.

Respectfully submitted,

BELL & INGRAM, P.S.

BY:


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TULALIP TRIBE'S LEGAL MEMORANDUM IN SUPPORT OF
HR 2792

A BILL TO CLARIFY INDIAN TREATIES AND
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BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
COMMITTEE ON WAYS AND MEANS, UNITED STATES
HOUSE OF REPRESENTATIVES

DECEMBER 14, 1987

INTRODUCTION

This Memorandum is submitted on behalf of the Tulalip Tribes of Washington in support of HR 2792, a Bill which would clarify the non-taxable status of income derived by Indians from the exercise of fishing rights secured by treaties and executive orders. Stanley G. Jones, Sr., Chairman of the Tulalip Tribes, testified before the United States House of Representatives at its December 14, 1987 hearings on HR 2792 and submitted a written statement for the hearing record. This Memorandum supplements that testimony and statement.

This Memorandum is also intended to supplement the discussion contained in the September 21, 1983 Opinion rendered by William H. Coldiron, then Solicitor for the Department of the Interior, and the March 12, 1985 Opinion rendered by Frank K. Richardson, the then Solicitor of the United States Department of the Interior, reaffirming Solicitor Coldiron's opinion that income derived by Indians from the exercise of reserved treaty fishing rights are not subject to federal income taxation. A copy of each opinion is submitted herewith.

Also submitted herewith is a copy of an affidavit of Barbara Lane, a well-respected anthropological authority on the treaties in question.

THE TREATIES

The Tulalip Tribes of Washington ("Tribe") is a federally recognized Indian Tribe organized pursuant to the Indian Reorganization Act of 1934. The Tribe is a successor of several of the tribes and bands which signed the Treaty of Point Elliott in 1855 (12 Stat. 927), and has reserved treaty fishing rights under that treaty. See, United States v. Washington, 384 F. Supp. 312 (W.D. Wash. 1974) (United States v. Washington), Aff'd., 520 F.2d 676 (C.A. 9 1975), cert. denied, 423 U.S. 1086 (1976), substantially aff'd., Washington v. Fishing Vessel Ass'n., 443 U.S. 658 (1979) ("Fishing Vessel"); and United States v. Washington, 459 F. Supp. 1020, 1039, 1058-60 (W.D. Wash. 1974-78) ("Post-Trial Decisions"). The Treaty of Point Elliott is one of the six treaties negotiated with Washington tribes by territorial Governor Isaac Stevens ("Stevens Treaties"). Fishing Vessel, 443 U.S. 662, Fn. 2.

In the Stevens Treaties, Washington tribes voluntarily ceded their title to vast areas of land reserving but small reservations for their exclusive use. Fishing Vessel, 443 U.S. 662. The United States induced the tribes to reach this peaceful resolution of their title claims, and thereby avoided the possibility of armed conflict, by assuring the tribes that the treaties would reserve their fishing rights, that the United States would protect those rights and that they would be secure. The reserved treaty fishing rights were the principal economic benefit retained by the Indians in the bargain thus made. It is inconceivable the Indian negotiators would have agreed to the treaties if it had been in any way suggested that their future entitlement to the benefits of the reserved treaty rights could in any

way be impaired or diminished by the United States through taxation or otherwise.

When the relevant treaties were signed, the anadromous fishery had tremendous importance to Washington Indian tribes ("...all of them shared a vital and unifying dependence on anadromous fish." 443 U.S. 664). At and long before treaty times, the commercial harvest and sale of anadromous fish was used to provide the Indians' livelihood. Fishing Vessel, 443 U.S. 665 ("fish constituted a major part of the Indian diet, and was used for commercial purposes, and indeed was traded in substantial volume."). The Supreme Court took special note of the Indians' extensive commercial trade in fish:

"At the time of the treaties, trade was carried on among the Indian groups throughout a wide geographic area. Fish was a basic element of the trade. There is some evidence that the volume of this intra-tribal trade was substantial, but it is not possible to compare it with the volume of present day commercial trading in salmon. Such trading was, however, important to the Indians at the time of the treaties. In addition to potlatching...there was a considerable amount of outright sale and trade beyond the local community and sometimes over great distances. In the decade immediately preceding the treaties, Indian fishing increased in order to accommodate increased demand for local, non-Indian consumption and for export, as well as to provide money for purchase of introduced commodities and to obtain substitute non-Indian goods for native products which were no longer available because of the non-Indian movement into the area. Those involved in negotiating the treaties recognized the contribution that Indian fishermen made to the territorial economy because Indians caught most of the non-Indians' fish for them, plus clams and oysters." 384 F. Supp. at 351-352 (citations to record omitted). See also, Id. at 364 (Makah Tribe 'maintained from time immemorial a thriving economy based on commerce' in 'marine resources')."

Fishing Vessel, 443 U.S. 665, fn. 7. The Supreme Court also noted that:

"In late December 1854, one territorial official wrote the Commissioner of Indian Affairs that '[t]he Indians on Puget Sound...form a very considerable portion of the trade of the Sound.... They catch most of our fish, supplying not only our people with clams and oysters, but salmon to those who cure and export it.'"

Fishing Vessel, 443 U.S. 666, fn. 8.

During the treaty negotiations, the United States negotiator, Territorial Governor Isaac Stevens, and his associates,

"...were well aware of the 'sense' in which the Indians were likely to view assurances regarding their fishing rights. During the negotiations, the vital importance of the fish to the Indians were repeatedly emphasized by both sides, and the Governor's promises that the treaties would protect that source of food and commerce were crucial in obtaining the Indians' assent." (Emphasis added)

Fishing Vessel, 443 U.S. 676.

The Supreme Court recognized that "...these treaties confer enforceable special benefits on signatory Indian tribes", and, in rejecting the state's argument that the treaties only conferred an equal opportunity to fish, the Court noted that:

"Such a 'right', along with the \$207,500 paid the Indians, would hardly have been sufficient to compensate them for the millions of acres they ceded to the Territory."

Fishing Vessel, 443 U.S. at 673, fn. 20 and 677.

As indicated, the vital importance of the fishery to the Indians was repeatedly emphasized during the treaty negotiations. This is hardly surprising given the fact that the treaty fishery was the principal economic resource reserved by the Indians under the Stevens treaties in which they ceded title to millions of acres of land. As noted by the Supreme Court, the 'United States' promises that the treaties would protect that source of commerce were crucial in obtaining the tribes' agreement to the treaties, which resulted in peaceful resolution of Indian title claims to vast areas without armed conflict. In thus resolving such matters by negotiation, the Washington tribes relied heavily on the promises and assurances made by the United States negotiators and upon the good faith and honor of the United States. The Indians were vitally interested in protecting the fishing rights they reserved in the treaties, and

"...they were invited by the white negotiators to rely and in fact did rely heavily on the good faith of the United States to protect that right."

Fishing Vessel, 443 U.S. 667.

In relying upon the United States' good faith and honor in the treaty negotiations, the tribes were in a particularly vulnerable and disadvantageous position due to the language barriers that existed. In its discussion of the Indian negotiators' vital interest in protecting their reserved fishing rights, and their heavy reliance upon the good faith of the United States to do so, the Supreme Court noted that:

"There is no evidence of the precise understanding the Indians had of any of the specific English terms and phrases in the treaty."

Fishing Vessel, 443 U.S. 666. The difficulty arose due to inadequacies in the "Chinook jargon" in which the treaty was explained to the Indians.

"Indeed, the translation of the English words was difficult because the interpreter used a 'Chinook, jargon' to explain treaty terms, and that jargon not only was imperfectly (and often not) understood by many of the Indians, but also was composed of a simple 300-word commercial vocabulary that did not include words corresponding to many of the treaty terms."

Fishing Vessel, 443 U.S. 667, fn. 10.

The long-recognized rule of Indian treaty interpretation is that the United States, the party with superior negotiating skills and superior knowledge of the language in which the treaty is recorded, has a responsibility to avoid taking advantage of the other side. Therefore, Indian treaties are construed in the sense they would naturally be understood by the Indians--not according to technical legal meanings:

"A treaty, including one between the United States and an Indian tribe, is essentially a contract between two sovereign nations. (Citations omitted). When the signatory nations have not been at war and neither is the vanquished, it is reasonable to assume they were negotiated as equals at arm's length. There is no reason to doubt that this assumption applies to the treaty at issue here. (Citation omitted).

"Accordingly, it is the intention of the parties, and not solely that of the superior side, that must control any attempt to interpret the treaties. When Indians are involved, this Court has long given special meaning to this rule. It has held that the United States, as the party with

the presumptively superior negotiating skills and superior knowledge of the language in which the treaty is recorded, has a responsibility to avoid taking advantage of the other side. "[T]he treaty must therefore be construed, not according to the technical meaning of its words to learned lawyers, but in the sense in which they would naturally be understood by the Indians." (Citation omitted). This rule, in fact, has thrice been explicitly relied on by the Court in broadly interpreting these very treaties in the Indians' favor...." (emphasis added)

Fishing Vessel, 443 U.S. 675-676. \1

In negotiating the Stevens treaties, the United States' negotiators did not bargain for, or even request, that the Indians confer upon the United States any right to restrict or impair the Indians' reserved fishing rights, either by taxation or otherwise. As the Supreme Court noted in Fishing Vessel:

"There is nothing in the written records of the treaty councils or other accounts of discussions with the Indians to indicate that the Indians were told that their existing fishing activities or tribal control over them would in any way be restricted or impaired by the treaty. The most that could be implied from the treaty context is that the Indians may have been told or understood that non-Indians would be allowed to take fish at the Indian fishing locations along with the Indian. 384 F. Supp. at 357."

Fishing Vessel, 443 U.S. 668, fn. 12. Id. While records are clear the United States' negotiators were well aware of and intended to protect the Indians' existing commercial fishery, see Affidavit of Barbara Lane, nothing in the negotiation records indicates in any way that the United States intended to tax the benefits of the Indians' reserved fishing rights. Id. The United States' negotiators did not in any way suggest to the Indians that the United States intended to or would be able to tax the benefits of

1. In applying this principle of interpretation to the Stevens treaties, it is important to keep in mind that the Indians fishing rights were not granted by the United States to the Tribes, but rather were pre-existing rights of the Indians which were reserved. In this classic statement of the "reserved rights" doctrine, the Supreme Court noted the limited right to share in the fishery which the Indians gave to the non-Indians:

"The right to resort to the fishing places in controversy was a part of the larger rights possessed by the Indians, upon the exercise of which there was not a shadow of impediment, and which were not much less necessary to the existence of the Indians than the atmosphere they breathed. New conditions came into existence, to which those rights had to be accommodated. Only a limitation of them, however, was necessary and intended, not a taking away. In other words, the treaty was not a grant of rights to the Indians, but a grant of rights from them - a reservation of those not granted. And the form of the instrument and its language was adapted to that purpose. Reservations were not of particular parcels of land, and could not be expressed in deeds as dealings between private individuals." (Emphasis added).

United States v. Winans, 198 U.S. 371, 381 (1905); See, also Mason v. Sams, 5 F. 2d 255, 258 (W.D. WA 1925). The Indians kept what they did not grant. Given this inherent aspect of the transaction, it could not be expected that the Indians understood or even had a reason to suspect that the United States would receive a right to take away any portion of the Indians income from their reserved fishing, unless the Indians agreed their reserved rights would be subject to such diminishment.

their reserved fishing rights. Id.

The treaty negotiation records do not indicate that Governor Stevens told the Indians the United States would take away any portion of the income they derived from fishing. The treaty negotiation records indicate that Governor Stevens told the Indians:

"Are you not my children and also children of the Great Father? What will I not do for my children, and what will you not do for yours? Would you not die for them? This paper is such as a man would give to his children and I will tell you why. This paper gives you a home. Does not a father give his children a home?...This paper secures your fish. Does not a father give food to his children?"

Fishing Vessel, 443 U.S. 667, fn. 11. The Indians could not have understood such assurances to mean they would have to pay the United States any portion of their fishing income or give the United States any portion of the fish they caught.

Given the serious limitations of the Chinook jargon, elaborate circumlocutions would have been needed in order to explain the concept of a tax upon the fishery to the Indian negotiators. See Affidavit of Barbara Lane. No such language or explanation is found in any of the records of the Treaty Councils. Id. It is simply inconceivable that the Indians had any understanding that the United States would subsequently be able to tax away the reserved treaty fishing benefits which were the essence of the Indians' treaty bargain, or that they would have signed the treaties if they had been told this. Indeed, the Indians had every reason to believe that their ceding of millions of acres of land was the only payment they would ever have to make to enjoy the total protection the treaty would provide to their reserved fisheries, both as a source of food and commerce.\2

It is beyond question that taxation would be a serious impairment and diminishment of the reserved treaty fishing rights. As the Supreme Court has noted, the "...power to tax the exercise of a privilege is the power to control or suppress its enjoyment." Murdock v. Pennsylvania, 319 U.S. 105, 112 (1943).

In Tulee v. Washington, 315 U.S. 681 (1942), the United States Supreme Court held that the State of Washington's imposition of a license fee upon the exercise of the reserved treaty fishing right could not be reconciled with a fair construction of the treaty and was thus impermissible. The treaty in question was one of the Stevens treaties. The State had sought to impose the fee as a condition of the Indians' exercise of the reserved treaty fishing right. The Court in Tulee noted that the issue must be addressed by viewing the treaty in light of the Court's

"...responsibility to see that the terms of the treaty

2. If the United States did indeed have some unexpressed intention to deprive or diminish the benefit of the Indians' reserved fishing rights through taxation, and failed to express this intent to the Indians in the treaty negotiations, this tactic would certainly constitute the utmost in bad faith and dishonorable dealings and an absolute flaunting of the United States' negotiators' responsibilities "to avoid taking advantage of the other side". The Tribe simply does not believe that the United States' negotiators had any such dishonorable intention to lure the Indians into a treaty based upon solemn promises to protect the reserved fishery as a vital source of commerce, and later diminish those benefits through income taxation. Indeed, the federal income tax was not even enacted until more than sixty years after the treaties were made, and then only after the Sixteenth Amendment was adopted to make such taxation constitutional. In any event, even if such unexpressed intention had existed, the well-established rules of treaty interpretation discussed above would prevent any such result.

are carried out, so far as possible, in accordance with the meaning they were understood to have by the tribal representatives at the council, and in a spirit which generously recognizes the full obligation of this Nation to protect the interest of a dependent people"

The Court held that

"...exaction of fees as a prerequisite to the enjoyment of fishing in the 'usual and accustomed places' cannot be reconciled with a fair construction of the treaty."

315 U.S. at 685. The Court noted that such a fee impermissibly "...acts upon the Indians as a charge for exercising the very right their ancestors intended to reserve." *Id.* Sampson Tulee was an individual Yakima treaty fisherman who was represented by the United States in the litigation. The view of the treaty adopted by the Supreme Court was the same as that advocated by the United States.

In Puyallup Tribe v. Department of Game (Puyallup I), 391 U.S. 392, 401, fn. 14, the Supreme Court referred to its holding in Tulee, citing Murdock v. Pennsylvania, *supra*, for the proposition that the power to tax the exercise of a privilege is the power to control or suppress its enjoyment, and made clear that the Tulee prohibition upon charges on the reserved treaty fishery was not limited to license fees, but included taxation in general.

While the issue before the court in Tulee v. Washington involved a state charge, the principle applies to the United States as well. The limitations imposed by the treaties upon the state's authority occur by virtue of the supremacy clause of the United States Constitution. The United States, as a party to the treaties, is, of course, directly bound by them. United States v. Winans, 198 U.S. 371, 381-382. Hoh v. Baldridge, 522 F. Supp. 683. (W.D. Wa. 1981).³ In fact, in Mason v. Sams, 5 F. 2d 255 (W.D. Wa. 1925), the protections of the Stevens Treaties were applied to prevent the United States from charging a royalty of 5¢-25¢ upon the gross fishing receipts of a member of the Quinault Tribe. The Commission of Indian Affairs had sought to impose such a royalty, and the court held that the Commissioner lacked the authority to impose this levy because the treaty guaranteed the fishing rights of each individual member of the Tribe and the federal government had no right to take a share of these fish for its own purposes, no matter how beneficial these purposes might seem. 5 F. 2d at 158.

The Commissioner of Internal Revenue certainly has no more right to take a portion of the Indian's fish, or a portion of the income derived from the Indian's commerce in such fish, than did the Commissioner of Indian Affairs. The results in Tulee v. Washington and in Mason v. Sams are entirely consistent with and required by the assurances given by the United States negotiators that the treaties would protect the source of commerce provided by the Indian's reserved fishing rights. It is very surprising and upsetting to the Tribe that any agency of the United States would suggest, in modern times, that the treaties do not provide such protection and that the United States may freely go back on its word and take away any portion of the income treaty fishermen earn from the reserved treaty fishery. HR 2792 provides an important and timely opportunity for Congress to reaffirm the nation's word given in the Stevens Treaties by clarifying for all

3. In Winans, the Court stated:

"The reservations [of fishing rights] were in large areas of territory, and the negotiations were with the tribe. They reserved rights, however, to every individual Indian, as though named therein...and the right was intended to be continuing against the United States and its grantees."

198 U.S. at 381-82.

time the non-taxable status of treaty fishing income.

TAXATION OF TREATY FISHING INCOME IS INCONSISTENT
WITH THE UNITED STATES TRUST RESPONSIBILITIES

The signing of the Stevens Treaties placed "...substantial duties upon the United States." No Oilport! v. Carter, 521 F. Supp. 334, 373 (W.D. Wash. 1981). As indicated, the United States negotiators expressly promised the Indians that the treaties would "secure" their reserved fishery and the United States promises that the treaties would protect that source of commerce were crucial in obtaining the Indians assent. The responsibilities of the United States to guard and protect the promised treaty benefits are also:

...reinforced by the undisputed existence of a general trust relationship between the United States and the Indian people. This Court has previously emphasized 'the distinctive obligation of trust incumbent upon the Government in its dealings with these dependent and sometimes exploited people.' Seminole Nation v. United States, 316 US 286, 296, 86 L. Ed. 1480, 62 S. Ct. 1049 (1942). This principle has long dominated the Government's dealings with Indians. United States v. Mason, 412 U.S. 391, 398, 37 L. Ed. 2d 22, 93 S. Ct. 2202 (1973); Minnesota v. United States, 305 U.S. 382, 386, 83 L. Ed. 235, 59 S. Ct. 292 (1939); United States v. Shoshone Tribe, 304 U.S. 111, 117-118, 82 L. Ed. 1213, 58 S. Ct. 794 (1938); United States v. Candelaria, 271 U.S. 432, 442, 70 L. Ed. 1023, 46 S. Ct. 561 (1926); McKay v. Kalyton, 204 U.S. 458, 469, 51 L. Ed. 566, 27 S. Ct. 346 (1907); Minnesota v. Hitchcock, 185 U.S. 373, 396, 46 L. Ed. 954, 22 S. Ct. 650 (1902); United States v. Kagama, 118 U.S. 375, 382-384, 30 L. Ed. 228, 6 S. Ct. 1109 (1886); Cherokee Nation v. Georgia, 5 Pet. 1, 17, 8 L. Ed. 25 (1831).

United States v. Mitchell, 463 U.S. 206, 77 L. Ed. 2d 580, 596-597 (1983).

Under this trust relationship an Indian tribe is "entitled to rely on the United States, its guardian, for needed protection for its interests." United States v. Creek Nation, 295 U.S. 103, 110 (1935). It is the federal government, rather than the states or local governments, which have this special role as protector. United States v. Kagama, 118 U.S. 375, 384 (1886).

The duties imposed by the trust relationship apply to all federal agencies (including the Internal Revenue Service) when they are dealing with Indian interests. Seminole Nation v. United States, *supra*; Nance v. Environmental Protection Agency, 645 F. 2d 701, 711, (9th Cir. 1981); *e.g.*, Hoh v. Baldrige, *supra*.

The federal trustee is subject to at least the same standards applicable to private trustees. United States v. Mason, 412 U.S. 391, 398 (1973); Manchester Band of Pomo Indians, Inc. v. United States, 363 F. Supp. 1238, 1245 (N.D. Cal. 1973). However, Seminole Nation v. United States, *supra*, suggests even a higher standard than that imposed on private trustees. As President Nixon pointed out in his 1970 message to Congress, 116 Cong. Rec. at 231-35, "[e]very trustee has a legal obligation to advance the interests of the beneficiaries of the trust without reservation and with the highest degree of diligence and skill."

The treaty reserved right to take fish is an expressly protected property interest which the United States has a trust responsibility to protect from diminishment. Colville Confederated Tribes v. Walton, 647 F. 2d 42, 48 (9th Cir. 1981), *cert. denied*, 102 S. Ct. 657 (1981); Whitefoot v. United States, 293 F. 2d 658, 659 (Ct. Cl. 1961), *cert. denied*, 369 U.S. 818 (1962); Pyramid Lake Paiute Tribe v. Morton, 345 F. Supp. 252 (D.D.C. 1973). Northern Paiute Tribe v. United States, 30 Ind. Cl. Comm. 210 (1973).

To the extent the Indians are made to give up part of their catch, or the proceeds from the commerce in their catch, the promises of the United States negotiators that the treaties would protect and make secure that source of commerce, are absolutely meaningless. Prior to the treaties "there was not a shadow of impediment" upon the Indians' fishery as their principal source of commerce. The treaties certainly do not purport to confer upon the United States any right to now create such an impediment, either in the form of a tax which requires a direct payment to the United States (the other party to the treaty) of income earned from commerce in fish, or which requires the Indians to deliver to the United States a portion of their catch. Any taxation, or attempt at taxation, of this treaty protected source of fishery commerce would be an absolute and total breach of the United States' trust responsibilities and a repudiation of the solemn promises and assurances made by the United States treaty negotiators.

THE INTERNAL REVENUE CODE DOES NOT ABROGATE THE TREATIES

While Congress' power to abrogate a treaty exists, such intention is not to be lightly imputed. See, Menominee Tribe v. United States, 391 U.S. 404, 412-413 (1968), where the Court stated:

"While the power to abrogate those rights exists (see Lone Wolf v. Hitchcock, 188 U.S. 553, 564-567...), the intention to abrogate or modify a treaty is not to be lightly imputed to the Congress. Pigeon River Co. v. Cox Co., 291 U.S. 138, 160... See also, Squire v. Capoeman, 351 U.S. 1...."

In considering whether a particular statute evidences a congressional intent to abrogate a treaty, the courts have always resolved doubts in favor of the Indians by attributing to Congress an intent to act in the manner most consistent with the Nation's trust obligations:

"While there is legally nothing to prevent Congress from disregarding its trust obligations and the abrogating treaties or passing laws inimical to the Indians' welfare, the courts, by interpreting ambiguous statutes in favor of Indians, attribute to Congress an intent to exercise its plenary power in the manner most consistent with the Nation's trust obligations. See Squire v. Capoeman, 351 U.S. 1, 7-8, 76 S. Ct. 611, 100 L. Ed. 883 (1956)."

Santa Rosa Band of Indians v. Kings County, 532 F. 2d 655, 660 (CA 9 1975), cert. denied 429 U.S. 1038. The courts have generally required express language sufficient to indicate a congressional intent to abrogate a treaty right. See, e.g., Menominee Tribe v. United States, *supra*, 391 U.S. at 408-410. In Menominee, the Supreme Court refused to construe legislation terminating the federal relationship with the Menominee Tribe as a backhanded abrogation of implied hunting and fishing rights which were not mentioned. *Id.*

Nothing in the Internal Revenue Code, or its legislative history, contains even the slightest reference to the Indians' reserved treaty fishing rights, much less an indication that Congress intended to abrogate or partially abrogate the treaties by taking away all or part of their reserved benefits through taxation.

As property rights, the Indians' reserved fishing rights are subject to the protection of the Fifth Amendment of the United States Constitution. Accordingly, Congress' power to modify treaties subject to the Fifth Amendment's taking clause. Shoshone Tribe v. United States, 299 U.S. 476 (1936); Choate v. Trapp, 224 U.S. 665 (1912). Presumably, if Congress had intended the Internal Revenue Code to abrogate or partially abrogate the treaties, by taxing away all or part of the fishing benefits reserved thereunder, it would have expressly said so, both in the statute and its legislative history, and would have established a fair and just procedure for determination and payment of the Fifth Amendment compensation claims that would arise from the taking. The total absence of any congressional

statement on these subjects:

"...has significance in the application of the canons of construction applicable to statutes affecting Indian immunities, as some mention would normally be expected of such a sweeping change in the [taxation] status of tribal government and reservation Indians had been completed by Congress."

Bryan v. Itasca County, 426 U.S. 373, 381 (1976).

Such canons of construction are, of course, unnecessary when Congress itself has the opportunity to speak to the issue directly. HR 2792 provides a vehicle by which Congress may send a clear message rejecting the notion that, by enacting the Internal Revenue Code, Congress in any way intended to disregard its trust obligations and abrogate or partially abrogate the Stevens treaties by taxing away the benefits of the fishery commerce the United States gave its word the treaties would protect.

CONCLUSION

Any conclusion that treaty fishing income, or a portion of the tribal treaty catch, may be taken away through taxation or otherwise cannot be reconciled with assurances given the Indians during the treaty negotiations, with their understanding of the treaty, or with the long-established rule of treaty construction that the United States has a duty to avoid taking advantage of Indians in treaty negotiations, particularly where the treaty is expressed in a language the Indians do not understand.

The essence of the treaty bargain was an assurance to the Tribes that their traditional reliance upon fishing for self-support would continue without encumbrance. Historically, both the Tribes and the United States have recognized that treaty fishing income is not subject to taxation. The Solicitor of the Department of the Interior, whose treaty interpretations are entitled to great weight, has recently reaffirmed the long accepted understanding that treaty fishing income is not subject to federal taxation.

The Tribes believe that the United States negotiators acted in good faith when they gave the word of the nation and that the United States would not later repudiate the solemn promises made by the treaty negotiators, and try to force the Tribes to make further payments to the United States, in addition to the heavy price their ancestors have already paid to reserve an unencumbering fishing right.

All federal agencies, including the Internal Revenue Service, share the federal trust responsibility to protect the Tribe's treaty fishing rights from diminishment.

The Tribes believe that Congress did not intend to abrogate any part of the treaties when it passed the Internal Revenue Code.

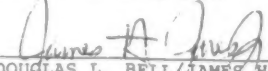
In the Tribe's view, Congress should adopt HR 2792 as an important reaffirmation of the Federal Government's commitment to honor the Nation's word given in 1855 treaties with Washington Indian tribes and to honor the Federal Government's trust responsibilities under those treaties.

HR 2792 is also consistent with President Reagan's strongly worded American Indian Policy Statement, issued on January 23, 1983, which reaffirms the Federal Government's commitment to the promotion of tribal self-sufficiency and economic development.

Respectfully submitted,

BELL & INGRAM, P.S.

BY:


DOUGLAS L. BELL/JAMES H. JONES, JR.
General Counsel for the
Tulalip Tribes of Washington

9 - LEGAL MEMORANDUM/HR 2792
JHJ27/27a



United States Department of the Interior

RECEIVED

OFFICE OF THE SOLICITOR
WASHINGTON, D.C. 20240

SEP 20 1983

September 21, 1983

BELL & INGRAM

Memorandum

To: Assistant Secretary--Indian Affairs
 From: Solicitor *William H. Goldstein*
 Subject: Federal income taxation of Stevens treaty fishing income

You have asked my opinion as to whether the income of members of certain Washington State treaty tribes generated from commercial fishing pursuant to the treaties is subject to the federal income tax. It is my opinion that fishermen who are members of tribes that have established treaty rights 1/ are exempt from federal income tax on fishing income earned pursuant to those treaties. This opinion does not apply to income earned by these same fishermen from other sources, such as fishing in nontreaty areas or to income derived from fish in excess of 50% of the available take. This opinion applies only to the federal income tax and does not apply to any other federal tax, excise, fee or license of any kind whatsoever. This opinion does not apply to State taxation in any form.

Your request for my opinion was, I understand, prompted by recent enforcement efforts of the Internal Revenue Service directed toward members of the Lummi, Tulalip, Puyallup and Swinomish Tribes 2/ and seeking to collect taxes on treaty

1/ United States v. Washington 384 F.Supp. 312 (W.D. Wash. 1974), aff'd 520 F.2d 676 (9th Cir. 1975) cert. denied, 423 U.S. 1086 (1976); United States v. Washington, 459 F.Supp. 1020 (W.D. Wash. 1978); Puget Sound Gillnetters Ass'n-v. U.S. District Court, 573 F.2d 1123 (9th Cir. 1978); Washington v. Wash. State Commercial Passenger Fishing Vessel Ass'n, 443 U.S. 658 (1979).

2/ In addition to these tribes, other tribes with treaty rights in Washington include the Hoh, Makah, Muckleshoot, Nisqually, Quileute, Quinault, Sauk-Suiattle, Skokomish, Squaxin Island, Stillaguamish, Upper Skagit, Nooksack, Suquamish, Port Gamble Band of Clallam Indians, Lower Elwha Tribal Community, Jamestown Band of Clallam Indians and the Yakima Indian Nation. A number of Oregon and Idaho Indian tribes have similar treaty fishing rights.

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fishing income. The Internal Revenue Service, of course, has responsibility for the interpretation and enforcement of the federal income tax laws. However, this Department has the primary responsibility within the federal government for the protection of Indian treaty fishing rights, including the authority and responsibility to interpret those rights. Accordingly, I believe it is not only appropriate but necessary that I interpret the treaties in this instance, where the interpretation of the federal tax laws under which the IRS is proceeding may conflict with fishing rights guaranteed under the treaties.

At the outset, I recognize that the only two decided cases on this issue have found that treaty fishing income is subject to the federal income tax. Strom v. Commissioner, 6 T.C. 621 (1946), aff'd per curiam, 158 F.2d 520 (9th Cir. 1947); Earl v. Commissioner, 78 T.C. 1014 (1982). However, as more fully discussed below, both decisions suffer from a lack of adequate consideration of the treaty rights involved. The Strom case was decided prior to both the United States v. Washington series of cases, which comprehensively interpreted the treaty fishing rights for the first time, and the Supreme Court's decision in Squire v. Capoeman, 351 U.S. 1 (1956), now the controlling case on questions of federal taxation of Indian trust and treaty income. The Earl case was brought pro se by an individual Indian fisherman, who never presented the court with the appropriate arguments on his own behalf. I do not believe therefore that these cases may be considered dispositive of the issue.

The Treaties

The treaties relevant to this issue are the six treaties negotiated by Governor Stevens in the 1850's with tribes in Washington State. 3/ Governor Stevens negotiated these treaties in order to clear title to the lands then in the Territory of Washington. The tribes and bands in Washington ceded title to vast areas of land in exchange for small reservations and various other guarantees. With immaterial variations, the treaties each provide:

3/ Treaty of Medicine Creek, December 26, 1854, 10 Stat. 1132; Treaty of Point Elliott, January 22, 1855, 12 Stat. 927; Treaty of Point No Point, January 26, 1855, 12 Stat. 933; Treaty of Neah Bay, January 31, 1855, 12 Stat. 939; Treaty with the Yakimas, June 9, 1855, 12 Stat. 951; Treaty of Olympia, July 1, 1855 and January 25, 1856, 12 Stat. 971.

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The right of taking fish at usual and accustomed grounds and stations is further secured to said Indians, in common with all citizens of the United States; and of erecting temporary houses for the purpose of curing; . . .

Article 4, Treaty of Point No Point, 12 Stat. 933.

This reservation of a right to fish has been interpreted seven times by the United States Supreme Court. United States v. Winans, 198 U.S. 371 (1905); Seufert Bros. Co. v. United States, 249 U.S. 194 (1919); Tulee v. Washington, 315 U.S. 681 (1942); Puyallup Tribe v. Department of Game (Puyallup I), 391 U.S. 392 (1968); Department of Game v. Puyallup Tribe (Puyallup II), 414 U.S. 44 (1973); Puyallup Tribe v. Department of Game (Puyallup III), 433 U.S. 165 (1977); Washington v. Washington State Commercial Passenger Fishing Vessel Ass'n (Fishing Vessel), 443 U.S. 658 (1979). These decisions establish the treaty right of the Indians to fish at their usual and accustomed places free of state regulation except where necessary for purposes of conservation and their right to take up to 50% of the available fish.

The fishing rights reserved by the Indians in the treaties included not only the right to fish for subsistence purposes but the right to fish for commercial purposes. At the time of the treaties, the Indians fished commercially, as recognized by the Supreme Court: "Fish constituted a major part of the Indian diet, was used for commercial purposes and indeed was traded in substantial volume." Fishing Vessel, *supra*, 443 U.S. at 665. Quoting from the district court's opinion, the Court described the Indians' reliance on fish for commercial purposes in more detail:

"At the time of the treaties, trade was carried on among the Indian groups throughout a wide geographic area. Fish was a basic element of the trade. There is some evidence that the volume of this intra-tribal trade was substantial, but it is not possible to compare it with the volume of present-day commercial trading in salmon. Such trading was, however, important to the Indians at the time of the treaties. In addition to potlatching, which is a system of exchange between communities in a social context often typified by competitive

gifting, there was a considerable amount of outright sale and trade beyond the local community and sometimes over great distances. In the decade immediately preceding the treaties, Indian fishing increased in order to accommodate increased demand for local non-Indian consumption and for export, as well as to provide money for purchase of introduced commodities and to obtain substitute non-Indian goods for native products which were no longer available because of the non-Indian movement into the area. Those involved in negotiating the treaties recognized the contribution that Indian fishermen made to the territorial economy because Indians caught most of the non-Indians' fish for them, plus clams and oysters."

443 U.S. at 665-666, n.7. The Court went on to find that, "During the [treaty] negotiations, the vital importance of the fish to the Indians was repeatedly emphasized by both sides, and [Governor Stevens'] promises that the treaties would protect that source of food and commerce was crucial in obtaining the Indians' assent." 443 U.S. at 676. The Supreme Court's conclusion that the treaty reserved to the Indians a right to take up to 50% of the available fish incorporates the Court's recognition of the role of fish in the Indians' economy and its recognition that the treaty negotiators understood that role and intended that the right to fish commercially was to be included in the rights reserved to the Indians.

Other Supreme Court decisions have held that the State of Washington could not require an Indian exercising off-reservation fishing rights to purchase a state fishing license, Tulee v. Washington, *supra*, and that the state's regulatory authority over treaty fishing was limited to that regulation reasonable and necessary for conservation. Tulee, Puyallup I, Puyallup II.

The United States, a direct party to the treaties, is of course bound by them and, absent exercise by Congress of its power to abrogate treaties, is subject to limitations similar to those imposed on the state with regard to the Indians' treaty rights. United States v. Winans, *supra*, 198 U.S. at 381-382; Hoh Indian Tribe v. Baldridge, 522 F. Supp. 683 (W.D. Wash. 1981).

The Tax Cases

In Squire v. Capoeman, 351 U.S. 1 (1956), the leading case on federal taxation of Indian income, the Supreme Court considered whether capital gains from the sale of standing timber on allotted lands was subject to the federal income tax. The Court held that the General Allotment Act of 1887, 24 Stat. 388, created an exemption from the tax in the circumstances before it. In reaching its conclusion, the Court acknowledged that the General Allotment Act did not contain an express exemption from the tax but nonetheless inferred an exemption from the government's undertaking, expressed in section 5 of the act, 25 U.S.C. §348, to convey the allotment at the end of the trust period "free of all charge or incumbrance whatsoever" and a 1906 amendment to section 6 of the act, 25 U.S.C. §349, which provides for removal of "all restrictions as to . . . taxation" after issuance of a fee patent. 351 U.S. at 6-8. The Court also found that the tax exemption was necessary to fulfill the purpose of the allotment system "to protect the Indians' interest and 'to prepare the Indians to take their place as independent, qualified members of the modern body politic.'" 351 U.S. at 9.

The Court responded thus to the government's argument that the case should be treated as an ordinary tax case:

We agree with the Government that Indians are citizens and that in ordinary affairs of life, not governed by treaties or remedial legislation, they are subject to the payment of income taxes as are other citizens. We also agree that, to be valid, exemptions to tax laws should be clearly expressed. But we cannot agree that taxability of respondents in these circumstances is unaffected by the treaty, the trust patent or the Allotment Act.

351 U.S. at 6.

While the Court acknowledged that a tax exemption must be clearly expressed, it found the necessary clear expression in language which, as noted above, implied, rather than expressly stated, the exemption. 351 U.S. at 6-8. It did so by reference to the intent of Congress in the General Allotment Act, 351 U.S. at 7-8, and to the principle of treaty and statutory construction which the Court described thus:

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Doubtful expressions are to be resolved in favor of the weak and defenseless people who are the wards of the nation, dependent upon its protection and good faith. Hence, in the words of Chief Justice Marshall, "The language used in treaties with the Indians should never be construed to their prejudice. If words be made use of, which are susceptible of a more extended meaning than their plain import, as connected with the tenor of the treaty, they should be considered as used only in the latter sense." [Citations omitted]

351 U.S. at 6-7. 4/

The Court in Capoeman held that the taxes from which the General Allotment Act was intended to shield allotments during the trust period included the federal income tax,

4/ This same rule was called upon by the Supreme Court in Fishing Vessel when it discussed the necessity of interpreting the Stevens treaties in accord with the intent of the parties:

[I]t is the intention of the parties, and not solely that of the superior side, that must control any attempt to interpret the treaties. When Indians are involved, this Court has long given special meaning to this rule. It has held that the United States, as the party with the presumptively superior negotiating skills and superior knowledge of the language in which the treaty is recorded, has a responsibility to avoid taking advantage of the other side. "[T]he treaty must therefore be construed, not according to the technical meaning of its words to learned lawyers, but in the sense in which they would naturally be understood by the Indians." This rule, in fact, has thrice been explicitly relied on by the Court in broadly interpreting these very treaties in the Indians' favor. [citations omitted]

443 U.S. at 675-676.

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even though that tax was not in existence at the time the General Allotment Act and its 1906 amendment were enacted. 351 U.S. at 7-8. The Court also rejected the argument put forth by the government that taxation of income derived from an allotment was sufficiently distinct from direct taxation of the allotment to make income taxation permissible even if direct taxation were prohibited. See 351 U.S. at 6.

Lower court decisions following Capoeman have established that the tax exemption in the General Allotment Act applies as well to allotments made under other allotment acts even though those acts do not necessarily contain the exemptive language of the General Allotment Act. Big Eagle v. United States, 300 F.2d 765 (Ct.Cl. 1962); United States v. Hallam, 304 F.2d 620 (10th Cir. 1962); Stevens v. Comm'r, 452 F.2d 741 (9th Cir. 1971). The courts reasoned that the other allotment acts had the same purpose as the General Allotment Act 5/ and therefore the same tax exemption should apply. These decisions recognize the essential Capoeman holding as founded upon the purpose of the General Allotment Act rather than upon the presence of specific language.

Other lower court decisions which have addressed the extent of the General Allotment Act exemption have held that income earned by an Indian from land purchased and placed in trust for him under §5 of the Indian Reorganization Act, 25 U.S.C. §465, shares the tax exemption, Stevens v. Comm'r, *supra*, but that income earned by an Indian from tribal or other Indians' trust land does not. Holt v. Comm'r, 364 F.2d 38 (8th Cir. 1966), *cert. denied*, 386 U.S. 931; Fry v. Comm'r, 557 F.2d 646 (9th Cir. 1977), *cert. denied*, 434 U.S. 1011; United States v. Anderson, 625 F.2d 910 (9th Cir. 1980), *cert. denied*, 450 U.S. 920. The courts in these latter cases viewed the purpose of the General Allotment Act as one to protect the allottees' property from encumbrance during the trust period, a purpose which would not be infringed by taxation of an Indian's income from other than his own trust property. Thus, while holding the income at

5/ The Court of Claims stated in Big Eagle, "Parallel congressional purposes [between the General Allotment Act and the Osage Allotment Act] are apparent, but the basic purpose is the one alluded to in Capoeman and that is to protect the property so that it will adequately serve the needs of the ward and finally bring him to a state of competency and independence. This chance is encouraged, if not guaranteed, by tax exemption." 300 F.2d at 771-772.

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issue taxable, these decisions recognized the relevance of the underlying purpose of a treaty or statute to the determination whether language contained therein expresses a tax exemption applicable to the particular circumstances at issue.

The courts in Holt, Fry, and Anderson, having found the General Allotment Act exemption inapplicable, were also unable to find any exemption in other statutes or treaties relevant to the income at issue. These decisions, as well as others, ^{6/} demonstrate that a tax exemption must derive from language in a treaty or statute and that an exemption may not be based on policy alone or on generalized references to treaties and statutes. E.g., Anderson, supra; LaFontaine v. Comm'r, 533 F.2d 382 (8th Cir. 1976). While holding the particular income at issue taxable, these courts have followed the basic teachings of Capoeman. As the Court of Appeals for the Ninth Circuit stated in Anderson, that court's most recent opportunity to consider the issue,

The rule that ambiguous statutes and treaties are to be construed in favor of Indians applies to tax exemptions, . . . but this rule "comes into play only if such statute or treaty contains language which can reasonably be construed to confer income [tax] exemptions" . . . "The intent to exclude must be definitely expressed, where, as here, the general language of the Act laying the tax is broad enough to include the subject-matter." (citations omitted.)

625 F.2d at 913. Further, in response to Anderson's argument that the policy of the General Allotment Act was applicable to his income earned from land other than his own (to which the court found the GAA exemption did not extend), the court stated,

Capoeman and every other Supreme Court and Ninth Circuit case have held that such policy arguments are fruitless in the absence of statutory or treaty language that arguably is an express tax exemption. Such policy arguments, however, might persuade courts to con-

^{6/} E.g., Comm'r v. Walker, 326 F.2d 261 (9th Cir. 1964) and Jourdain v. Comm'r, 617 F.2d 507 (8th Cir. 1980) cert. denied 449 U.S. 839, holding the salaries of tribal officials taxable.

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strue such arguable language, if any exists, actually to be an express tax exemption.

625 F.2d at 914, n. 6.

Analysis

Capoeman and its progeny make clear that a tax exemption must be based on treaty or statutory language, arguably creating an exemption, which is applicable to the income-producing activity at issue. Once such arguable language is identified, however, the policy or purpose of the treaty or statute may be called upon to determine whether the language does in fact create an exemption.

The language in the Stevens treaties expressly securing to the Indians the right of "taking fish at usual and accustomed grounds and stations" is such arguable language. First, it is directly applicable to the fishing activity at issue. Thus the instant situation is easily distinguishable from the taxpayers' unsuccessful attempts in Holt, Fry, and Anderson to apply the General Allotment Act tax exemption to income from land to which the General Allotment Act itself did not apply, and from attempts to infer tax exemptions from other statutory or treaty language which had no direct relation to the activity at issue. E.g., Anderson, Jourdain v. Comm'r; LaFontaine v. Comm'r. 7/

Second, the treaty provision states no limitation on the Indians' right to fish at usual and accustomed places other than that the right is to be exercised in common with citizens. On its face, the provision might well be read to prohibit any limitation on or diminishment of the fishing right other than the one specified. Of course, it might also be read

7/ In Anderson, the Ninth Circuit rejected arguments that sections 5, 6, and 16 of the Indian Reorganization Act, 25 U.S.C. §§465, 466, 476, conferred income tax exemptions for the income of an Indian derived from other Indians' land. 625 F.2d at 915-916. In Jourdain, the Eighth Circuit concluded that a treaty provision protecting Indians from "molestation by the United States" did not preclude income taxation of a tribal official's salary. 617 F.2d at 508-509. In LaFontaine, the Eighth Circuit found that the taxpayer, while citing more than thirty treaties, was unable to point to any provision therein exempting his income from taxation. 533 F.2d at 382.

otherwise but, at the least, an ambiguity exists, sufficient to call into play the rules of construction relating to ambiguous treaty and statutory provisions. Moreover, such an ambiguity makes the language arguably a tax exemption and so requires that the purpose and policy of the treaty be examined to determine whether a tax exemption does exist.

As discussed above at pages 3-4, the right to fish under the Stevens treaties includes the right to fish commercially and thus necessarily the right to earn income from fishing. Commercial fishing under the Stevens treaties, unlike many other economic activities in which Indians might engage, is thus specifically and expressly protected from interference by the United States.

As to the understanding of the Indian treaty negotiators which, as discussed above, the Supreme Court has considered critical to the proper construction of treaties, it is no more likely that the Indians understood that the federal government would tax their fishing right than that they understood that future states would be able to impose a charge upon it. To the contrary, the Indians were assured that they would be able to fish and trade as they had prior to the treaties, see p. 4, supra, when they paid no taxes and were not required, in any other manner, to turn over a portion of their fishing catch or proceeds to the government.

Accordingly, in my view, the rules of treaty and statutory construction relied upon by the Supreme Court in Fishing Vessel, Tulee, and Capoeman require the conclusion that the Stevens treaties reserved to the Indians the right to fish free from taxation, including federal income taxation.

The question remains whether the later-enacted Internal Revenue Code abrogated or modified this treaty right, because Congress, unlike the state legislatures, has the power to abrogate treaties with Indians. Lone Wolf v. Hitchcock, 187 U.S. 553 (1903).

In Capoeman, the Supreme Court concluded that the Internal Revenue Code did not modify the federal government's undertaking in the General Allotment Act to hold allotments free of taxation in order to fulfill the purpose of that Act. 8/

8/ "It is unreasonable to infer that, in enacting the Income tax law, Congress intended to limit or undermine the Government's undertaking. To tax respondent under these circumstances would . . . be 'at the least a sorry breach of faith with these Indians.'" 351 U.S. at 10.

Similarly, the Internal Revenue Code, in my view, did not modify the obligation undertaken by the federal government in the Stevens treaties to recognize the fishing rights reserved to the Indians. As the Supreme Court has stated, "While the power to abrogate [treaty] rights exists . . . 'the intention to abrogate or modify a treaty is not to be lightly imputed to the Congress.'" (citing, inter alia, Squire v. Capoeman.) Menominee Tribe v. United States, 391 U.S. 404, 412-413 (1968). In Menominee, the Court held that a statute terminating the federal relationship with the Menominee Tribe did not abrogate the tribe's treaty hunting and fishing rights even though those rights derived from a treaty provision creating the tribe's reservation and the reservation itself was extinguished pursuant to the termination act. The Court, as it said, "decline[d] to construe the Termination Act as a backhanded way of abrogating the hunting and fishing rights of these Indians." 391 U.S. at 412. The Court reiterated the principle of Menominee in Fishing Vessel, while holding that a 1930 agreement between the United States and Canada did not implicitly extinguish the Indians' treaty right. "Absent explicit statutory language," the Court stated, "we have been extremely reluctant to find congressional abrogation of treaty rights." 443 U.S. at 690.

One court has found an implied limitation upon Indian treaty hunting and fishing rights in the Eagle Protection Act, 16 U.S.C. §§668-668d. United States v. Fryberg, 622 F.2d 1010 (9th Cir. 1980), cert. denied, 449 U.S. 1004. 9/ Although the court acknowledged the lack of express language in the Eagle Protection Act abrogating or modifying the treaty, it relied upon a body of evidence in surrounding circumstances and legislative history which it believed indicated that Congress did intend that the act apply to treaty Indians, and upon the well-established principle that reasonable and non-discriminatory conservation statutes apply to treaty rights when such application is necessary to achieve the conservation purpose of the statutes. 10/ The court also noted that the modification of the Indians' hunting rights was relatively insignificant because eagles had never provided the Indians with "any commercial benefit or . . . subsistence

9/ The Eighth Circuit reached the opposite conclusion in United States v. White, 508 U.S. 453 (8th Cir. 1974), stating that "it was incumbent upon Congress to expressly abrogate or modify the spirit of the relationship between the United States and the Red Lake Chippewa Indians on their native reservation." Id., at 457-458.

10/ See cases cited supra at p. 4.

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value." 622 F.2d at 1014. Rather, the court noted, the only apparent reason to hunt eagles was for religious and ceremonial purposes, and the act contained an exception permitting use of eagle specimens for religious purposes. Id.

The situation with respect to taxation of treaty fishing income is clearly distinguishable from that addressed in Fryberg. The treaty modification which would be implicated by application of the federal income tax to income from treaty fishing is significant because it would diminish the value of the right to fish commercially, a right which, as discussed above, was clearly reserved to the Indians by the treaties. In effect, it would represent a taking by the United States of a portion of the right it guaranteed to the Indians. Moreover, unlike the conservation measures addressed in Fryberg and the Puyallup cases, supra, at 3-4, whose effectiveness depends upon their being applicable to everyone, the federal income tax can achieve its purpose even though it does not tax every source of income. The "necessity" rationale supporting application of conservation laws to treaty rights is therefore lacking in the case of tax laws. Accordingly, under the principles of Capoeman and Menominee, absent more explicit language than is present in the Internal Revenue Code, Congress should not be deemed to have modified the Stevens treaty fishing rights nor to have limited or undermined the federal government's undertaking in those treaties.

Strom and Earl are Incorrect

As I mentioned at the outset, the only two court decisions on federal income taxation of treaty fishing income have concluded that such income is subject to tax. Strom v. Commissioner, 6 T.C. 621 (1946), aff'd per curiam, 158 F.2d 520 (9th Cir. 1947); Earl v. Commissioner, 78 T.C. 1014 (1982).

The Strom decision predated both Squire v. Capoeman and the United States v. Washington series of cases. The case involved on-reservation fishing by two members of the Quinault Tribe. The Tax Court apparently considered only Article II of the Quinault treaty, 12 Stat. 971, which authorized the setting aside of a reservation (and by implication exclusive fishing rights therein) for the Quinaults, and not the explicit language in Article III reserving off-reservation fishing rights, which is the language that, as discussed above,

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creates the tax exemption. 11/ In any event, the court analyzed the case by reference to two Supreme Court cases holding taxable a competent Indian's share of tribal oil and gas royalty income and an Indian's investment income. 12/

The third case relied upon by the Tax Court in Strom, an earlier Tax Court decision affirmed by the Tenth Circuit, held that an Indian's restricted land and income therefrom was subject to the federal estate tax. 13/ In light of Capoeman and subsequent decisions, this case is not presently followed by the IRS. See Rev. Rul. 69-164, 1969-1 C.B. 220.

Applying these three cases, the Tax Court made several statements in support of its conclusion which, after Capoeman and Fishing Vessel, are unpersuasive. First, the court stated that there was no express exemption from tax in the treaty. As discussed above at pp. 5-9, we now know from Capoeman and its progeny that a tax exemption, although it must derive from specific language in a treaty or statute, need not be expressly couched in terms of nontaxability. Second, the court considered it significant that the fishing income at issue was in the "untrammelled possession" of the petitioners.

11/ Although the Article III language ostensibly applies only to off-reservation fishing, the Supreme Court held in Fishing Vessel that it also applies to on-reservation fishing, to the extent, at least, that the Indians' on-reservation catch counts in their 50% allocation. 443 U.S. at 687.

12/ Choteau v. Burnet, 283 U.S. 691 (1931); Superintendent of Five Civilized Tribes v. Comm'r, 295 U.S. 418 (1935). Both cases were distinguished by the Supreme Court in Capoeman, 351 U.S. at 9 and n.19. At the time Strom was decided, the Supreme Court appeared headed toward a rule that all or essentially all Indian income was taxable, a clear change of direction from the earlier understanding, derived from administrative rulings, that no Indian income from tribal or allotted lands was taxable. It was not until ten years after Strom that the Supreme Court in Capoeman limited the scope of the Choteau and Superintendent holdings and signalled a return of the pendulum to a point between the two extremes. For an historical analysis of the tax cases, see Putzi, "Indians and Federal Income Taxation," 2 N.Mex. Law Rev. 200 (1972); Fiske and Wilson, "Federal Income Taxation of Indian Income from Restricted Lands," 10 Land and Water Law Rev. 63 (1975).

13/ Landman v. Comm'r, 42 B.T.A. 958 (1940) aff'd 123 F.2d 787 (10th Cir. 1941) cert. denied 315 U.S. 810.

Capoeman sets no requirement that income from allotments (as distinguished from the allotments themselves) must be in restricted status in order to be tax exempt. Third, although it conceded that the federal government could not directly tax exercise of the fishing right, the court concluded that the government could tax income from fishing because a tax on income was not a burden on the fishing right. As discussed above at p. 7, the same distinction between a direct tax and a tax on income was argued by the government in Capoeman and rejected by the Supreme Court. Moreover, after Fishing Vessel, it is clear that the fishing right reserved by the treaties encompassed the right to sell fish, so that an income tax is, in fact, a burden on the fishing right. See supra, at pp. 10-11. Finally, the court appears to have premised its conclusion in part upon an error of fact, in that it apparently believed that the Indians at treaty time had not engaged in substantial commercial fishing. The court stated, for instance, "It is a far cry from the fishing operations of the members of an uncivilized tribe of Indians at the time of the execution of this treaty, and the commercial fishing business now carried on by the petitioners." 6 T.C. at 627. As we now know, however, the treaty Indians did in fact rely heavily upon fish for commercial purposes. See supra at 3-4.

In my view, the law as it has developed since Strom and the facts about Indian fishing that have come to light since Strom have undermined that decision so completely that it must now be considered unsound precedent.

Earl v. Comm'r, supra, is a 1982 Tax Court decision which reached the same conclusion as Strom. For a number of reasons, I do not believe it is persuasive authority. First, the opinion reflects the fact that the petitioner, who had no attorney, was unable to present the court with an adequate analysis of the treaties. It could not be expected, of course, that the Tax Court, which normally does not interpret treaties, would have, on its own, any appreciable familiarity with the long and complex litigation involving the Stevens treaties. Consequently, although the court briefly alluded to the lower court decisions in United States v. Washington, it failed to even mention Fishing Vessel or any of the other Supreme Court decisions interpreting the treaties and also failed to demonstrate an understanding of the principles of those cases.

Further, the Tax Court, as might be expected, relied heavily on Strom, which is, in my view, no longer good law. The court also interpreted Capoeman as essentially limited to

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its facts, contrary to the interpretation given that case by the federal courts of appeal. See discussion, supra, at pp. 7-9. Evidently, it was this interpretation of Capoeman that led the court to conclude that because the petitioner's fishing rights were not individually owned in the sense an allotment is individually owned, there could be no tax exemption. The court cited Fry, Anderson and other cases discussed supra at pp. 7-9 as support for that interpretation, based on the holdings in those cases that, in the circumstances at issue, income earned by Indians from tribal land was not exempt. The basis for those decisions, however, as discussed above, was not that income from tribal property is ipso facto taxable, but that the General Allotment Act exemption did not apply and, second, that no other exemption could be found in treaty or statute. The second basis for those decisions makes them inapplicable to treaty fishing income, for which an exemption is found in the treaties. For these reasons, particularly the lack of treaty analysis, I do not consider the Earl decision authoritative.



United States Department of the Interior

OFFICE OF THE SOLICITOR
WASHINGTON, D.C. 20240

MAR 12 1985

BIA-IA.0177

MEMORANDUM

To: Secretary

From: Solicitor

Subject: Federal income taxation of Stevens treaty fishing
income--Response to IRS opinion of November 23, 1983

You have asked me to comment on the legal arguments made in an opinion of the Office of Chief Counsel, Internal Revenue Service, dated November 23, 1983. The IRS opinion was issued in response to Solicitor Coldiron's memorandum of September 21, 1983, which expressed his view that income earned by members of certain Washington State treaty tribes in the exercise of their treaty fishing right is not subject to federal income taxation. The Internal Revenue Service takes the position that such income is subject to federal income taxation.

I have already conveyed to you my reconfirmation of Solicitor Coldiron's 1983 opinion. In my view, the principal weakness of the IRS response to that opinion is its misapprehension of the Supreme Court's holding in Squire v. Capoeman, 351 U.S. 1 (1956). The IRS considers Capoeman to require an express exemption from federal tax. However, the General Allotment Act, which the Supreme Court construed in Capoeman to have created a tax exemption for income from the sale of timber on allotted land, did not contain such a tax exemption in explicit terms. The Court inferred an exemption from the government's undertaking, expressed in section 5 of the act, 25 U.S.C. § 348, to convey the allotment at the end of the trust period "free of all charge or incumbrance whatsoever" and a 1906 amendment to section 6 of the act, 25 U.S.C. § 349, which provides for removal of "all restrictions as to . . . taxation" after issuance of a fee patent. That language, construed in conjunction with the underlying purpose of the General Allotment Act, i.e., "to protect the Indians' interest and 'to prepare the Indians to take their place as independent, qualified members of the modern body politic'", was sufficient, the Court held, to constitute the clear expression necessary to create a tax exemption. 351 U.S. at 6-9. See our 1983 opinion at 5-7.

The Internal Revenue Service takes the position that the policy underlying the Stevens treaties is not relevant to the determination of whether the treaties created a tax exemption. In so

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doing, the IRS ignores the practice established by the Supreme Court in Capoeman and followed consistently by the lower courts. That practice requires the identification of language in a treaty or statute which is arguably a tax exemption but then allows consideration of the underlying purpose of the enactment for the purpose of interpreting the arguable language to determine its tax exemption effect. The practice is discussed at some length in our 1983 opinion at pages 5-9. The proper role of policy in tax exemption analysis was succinctly described by the Ninth Circuit in United States v. Anderson, 625 F.2d 910 (9th Cir. 1980) cert. denied, 450 U.S. 920:

Capoeman and every other Supreme Court and Ninth Circuit case have held that . . . policy arguments are fruitless in the absence of statutory or treaty language that arguably is an express tax exemption. Such policy arguments, however, might persuade courts to construe such arguable language, if any exists, actually to be an express tax exemption.

625 F.2d at 914, n.6. IRS quotes this statement from Anderson for the proposition that express exemptive language in a treaty or statute is required. IRS opinion at 6-7. It misses, however, the real thrust of the statement, which is that policy may indeed be examined to assist in the determination of whether arguable language is an express exemption.

In a recent decision, the Ninth Circuit demonstrated that it is still of the view that the purpose of a statute is relevant to the determination of whether a tax exemption is present. That court held in Karmun v. Commissioner, 749 F.2d 567 (9th Cir. 1984), that income from the sale of reindeer or reindeer products by Alaska natives was not exempt from federal income tax because the Reindeer Act, 25 U.S.C. §§ 500-500n, did not contain a clear expression of intent to exempt. The court considered, inter alia, the purpose of the Reindeer Act, which it found to be the provision of a continuing food source to the Eskimos of northwestern Alaska through the establishment of a native-operated reindeer industry. The court concluded, "That purpose is not undermined by requiring the owners and operators of the reindeer herds to pay federal income taxes on their profits from the successful conduct of such operations." 749 F.2d at 570.

Thus, it is amply clear that past and present judicial analysis requires a consideration of the underlying purpose of the Stevens treaties in order to determine whether the language in the treaties which secures a fishing right to the tribes creates a tax exemption. To conclude that the "right of taking fish" does not include a tax exemption, without any attempt whatsoever to determine the scope of the fishing right intended by the parties to the treaties, would directly contravene the well-established principles of the tax cases. Authoritative judicial analysis of the scope of the treaty right is readily available in the well-developed body of law culminating in the Supreme Court's decision

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in Washington v. Washington State Commercial Passenger Fishing Vessel Ass'n (Fishing Vessel), 443 U.S. 658 (1979). In my view, there is neither a legal basis nor a practical justification for ignoring this body of law, as IRS does.¹

The treaty cases and their relevance to the tax exemption issue are discussed in our 1983 opinion at 2-4 and 9-12. One case cited in that opinion warrants some further mention. In Tulee v. Washington, 315 U.S. 681 (1942), the Supreme Court held that the State of Washington was precluded from imposing a license fee upon Indians engaged in the exercise of their Stevens treaty fishing right. In striking down the fee, the Court stated that it "acts upon the Indians as a charge for exercising the very right their ancestors intended to reserve" and "that such exaction of fees as a prerequisite to the enjoyment of fishing . . . cannot be reconciled with a fair construction of the treaty." 315 U.S. at 685.

Tulee involved a state license fee and not a federal tax. The rationale of that case, however, is relevant to any tax which would diminish the value of the treaty right because any such tax would necessarily be a "charge" for exercising the right. An income tax, in fact, might well be a more onerous burden on the right, because greater in amount, than a license fee would be. Further, the fact that an income tax does not fall directly upon the fishing activity but upon income therefrom is, under Capoeman, irrelevant if the treaty precludes taxation of the fishing right.² See 1983 Solicitor's opinion at 7.

Another concern I have with the IRS opinion is its heavy reliance on Strom v. Commissioner, 6 T.C. 621 (1946), *aff'd per curiam*, 158 F.2d 520 (9th Cir. 1947) and Earl v. Commissioner, 78 T.C. 1014 (1982). For the reasons discussed in our 1983 opinion at 12-15, I believe that Strom has been effectively eroded by

¹ IRS simply dismisses it: "The non-tax cases which are cited by Interior are, in our view, inapposite to the issue considered herein." IRS opinion at 10.

² The State of Washington recognizes that treaty fishermen are immune, even though not expressly exempted, from a state fish sales tax. See Washington Dept. of Fisheries v. DeWatto Fish Co., 660 P.2d 298, 301 (Wash. Ct. App. 1983). Such a tax, of course, is one which, like an income tax, would attach after exercise of the fishing right and would not therefore be a prerequisite to exercise of the right.

As explained in our 1983 opinion at page 4, the United States, absent exercise by Congress of its power to abrogate treaties, is subject to the same limitations as the states with regard to the Indians' treaty rights.

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subsequent case law and that Earl is seriously flawed. While these two Tax Court cases are clearly relevant to the present issue, they cannot be considered controlling because they are completely inadequate in treaty analysis.

I can understand that, from the perspective of the IRS, this matter may appear to be solely a tax issue, with respect to which Tax Court decisions might be considered controlling and federal tax cases might constitute the sole appropriate body of law by which to analyze the issue. This is not only a tax issue however; it is also an Indian treaty issue. There are two bodies of law which must be considered in relation to each other. The controlling cases here are not the two Tax Court cases but the two Supreme Court cases, Capoeman and Fishing Vessel, which represent the paramount authority in those two bodies of law. A proper analysis of the issue should begin with those cases and must relate the two bodies of law in proper perspective. This, IRS simply has not done.

I am somewhat concerned with some erroneous statements made in the IRS opinion about positions taken in our 1983 opinion. I point these out primarily for clarification purposes.

The IRS opinion states at page 6 that our 1983 opinion "argues that Interior Department's policies of promoting optimal land use on Treaty land with a goal towards eventual Indian economic independence precludes taxation of the fishing income earned by enrolled Tribal members." The 1983 opinion contains no such statement. Nor does it take the position, as the IRS opinion implies, that policy, standing alone, is a sufficient basis for a tax exemption. Our position on the proper role of policy is discussed above and at pages 5-9 of the 1983 opinion.

The IRS opinion states at pages 7-8 that "Interior's memorandum also places substantial reliance on the Ninth Circuit's statement in Stevens v. Commissioner, 452 F.2d 741, [746] (9th Cir. 1971), to the effect that as the agency charged with the administration of the Indian laws and responsible for drafting many of them, Interior's interpretation is entitled to 'great weight' and 'is not to be overturned unless clearly wrong.'" The IRS memo then proceeds at some length to construe the Stevens statement as applicable only to the facts at issue in that case. While our 1983 opinion cited the Stevens case for another proposition, it did not, in fact, cite or rely on the language quoted by IRS. That language, however, simply expresses a well-established general principle, and I find it somewhat puzzling that IRS considers it so alarming. This Department's authority to interpret federal Indian statutes and treaties derives from its paramount responsibility for Indian affairs within the federal government, just as the authority of the IRS to interpret

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the federal tax laws derives from its responsibility to administer those laws. Courts commonly look for guidance to federal agency interpretations of statutes within the jurisdiction of the agencies.

These last two points are minor ones, of course. My primary objections to the IRS opinion are, as discussed above, its incorrect analysis of Squire v. Capoeman and its failure to address the treaties which are at the heart of the issue under discussion.

Frank K. Richardson
Frank K. Richardson

fishery or upon the fishing right which the Indians reserved to themselves. On the contrary, Isaac Stevens, chief negotiator for the United States, promised the Indians at Point-no-Point: "This paper secures your fish."

8. As she reported in her initial report in United States v. Washington, "Available evidence suggests that Indian fishing increased in the pretreaty decade for three major reasons: (1) to accommodate increased demands for local non-Indian consumption and for export; (2) to provide money for the purchase of introduced commodities such as calico, flour, and molasses; and (3) to obtain substitute non-Indian goods for native products no longer available because of non-Indian movement into the area."

9. As she also concluded in that same report: "[T]he reservations were to be residential bases from which the Indians were to continue to utilize the total environment, including specifically all of their fishing locations, in order to maintain themselves and to contribute to the economy of the entire population.... The treaty commission clearly undertook to provide the Indians the means of participating and prospering in the economy of the Territory. The contribution was seen to be primarily in the fisheries."

10. Her conclusions found in her testimony at the trial of United States v. Washington were sound at the time and have been reinforced by the work she has done since 1973. The Indians understood that they retained the full rights to their usual and accustomed fisheries, wherever these may be, but that as owners of these rights, in the native way of looking at things, they were extending use rights to the non-Indians to share in the resources. She does not believe that the Indians thought they were giving up anything in the Treaty as regards fishing rights.

11. At the time of the Treaty Councils, 1854-56, the United States did not impose an income tax upon its citizens.

12. She has seen nothing in the records of the Treaty Councils, in the correspondence between Isaac Stevens and Washington, D.C., or in the diaries and other records kept by Stevens or the other United States Treaty Commissioners or their staff which indicates in any way that the United States or its agents intended to tax the fishing right or raise revenue for the United States directly from the Indian fishery.

13. The United States negotiators were aware of and intended to protect the Indian commercial fishery that was in existence at Treaty times, while allowing for a non-Indian commercial fishery at the same time.

14. The major purpose of the United States in negotiating the Treaties with the Indians of the Pacific Northwest was to clear title to the land in a peaceful manner without armed conflict.

I swear under the perjury laws of the State of Washington
that the foregoing is true and correct.

Dated this 18 Day of April, 1985, at Seattle, Washington.

Barbara Lane
BARBARA LANE

Mr. ANDREWS. Thank you, Mr. Jones.

Ms. Roessel, did you have a statement that you wanted to make?

**STATEMENT OF FAITH ROESSEL, STAFF ATTORNEY, NATIVE
AMERICAN RIGHTS FUND**

Ms. ROESSEL. Yes, I do.

Chairman Andrews, thank you for the opportunity to testify on this legislation. I will be very brief.

I am a staff attorney with the Native American Rights Fund. NARF is a public interest, nonprofit law firm that represents Indian tribes and groups and Indian individuals across the Nation. We have offices in the District of Columbia, Boulder, Colorado, and Anchorage, Alaska.

I am testifying today in support of this legislation. While much of the attention on Indian fishing has been in the Northwest area of the United States, we represent clients in the Great Lakes area.

The Chippewa-Ottawa Treaty Fishery Management Authority is one such client. They are composed of three tribes, the Sault Ste. Marie, the Bay Mills, and the Grand Traverse Chippewas, all in Michigan. Also, we represent two individual Indian clients who are fishermen, who have been engaging in treaty fishing activity.

The Internal Revenue Service has sought to impose Federal income taxes on these two individuals and NARF is representing them before the U.S. Tax Court, challenging such an imposition. If anything, what NARF is finding is that increasingly there are attorneys and other Indian individuals that are inquiring with us as to the IRS' imposition of Federal income tax on Indian fishing.

Just last week, there was a call from a fisherman from one of the Michigan tribes. The IRS had just seized his savings account, checking account, and his daughter's savings account, which had about \$100 in it. This is all contrary to what the Internal Revenue Service had promised to Senator Evans in correspondence that he submitted earlier to the committee for the record. That is, no penalties would be imposed pending the outcome of this legislation.

The nature and the scope of the Chippewa-Ottawa Treaty fishing right is well-defined and has been recognized by the lower Federal courts and the Supreme Court. The treaty phraseology is a bit different than the Stevens treaty language, but nonetheless, the treaty fishing right is recognized.

In closing, we have submitted for the record a rather detailed legal analysis. Also, I think we need to bear in mind that the legislation before this committee is a clarification of treaty obligations and is not a tax exemption for a special interest group. The Department of the Interior has correctly interpreted the state of the law and we are pleased that Mr. Ragsdale of the Bureau of Indian Affairs was here to testify on behalf of the administration.

We urge the Committee on Ways and Means to likewise concur with the House Interior Committee and with the Senate Select Committee on Indian Affairs in the Senate which have all favorably reported out this legislation.

[The statement of Ms. Roessel follows:]

TESTIMONY OF THE
NATIVE AMERICAN RIGHTS FUND
ON BEHALF OF
THE CHIPPEWA-OTTAWA TREATY FISHERY
MANAGEMENT AUTHORITY,
KENNETH TEEPLE AND DONALD ANTHONY

Chairman Rangel, members of the Committee, my name is Faith Roessel. I am a staff attorney at the Native American Rights Fund. The Native American Rights Fund is a public interest law firm that represents Indian tribes and Indian individuals.

I am testifying today in support of H.R. 2792, a bill to clarify Indian treaties and executive orders with respect to fishing rights. While much of the attention on Indian fishing rights has focused on the Northwest Indian tribes, NARF represents clients engaged in fishing in the Great Lakes area.

I am appearing on behalf of the Chippewa-Ottawa Treaty Fishery Management Authority, and on behalf of Kenneth Teeple and Donald Anthony, individual members of the Sault St. Marie Tribe of Michigan. The Chippewa-Ottawa Treaty Fishery Management Authority was established in 1980, and is dedicated to the protection and enhancement of Chippewa-Ottawa fishing rights recognized and respected by several 19th Century treaties with the United States. ^{1/} Messrs. Teeple and Anthony exercise commercial and subsistence fishing rights pursuant to those treaties. For the past seven years both have been the subject of efforts by the Internal Revenue Service (IRS) to impose federal income taxes upon income directly derived from the exercise of said rights. Both are currently in United States Tax Court challenging the IRS's imposition of taxes on their treaty-derived fishing income.

Nature and Scope Of
The Chippewa-Ottawa Treaty Fishing Right

By the Treaty with the Ottawa, Etc., of March 28, 1836, the Chippewa and Ottawa Nations ceded a tract of land constituting approximately the northern third of Michigan's Lower Peninsula and the eastern half of its Upper Peninsula. 7 Stat. 491 (1836). Under the 1836 Treaty, the Chippewa reserved certain rights in the ceded area:

Article Thirteenth. The Indians stipulate for the right of hunting on the lands ceded, with the other usual privileges of occupancy, until the land is required for settlement.

7 Stat. 495. (Emphasis added.)

The language "other usual privileges of occupancy" has been construed by the courts to include the right to fish commercially and for subsistence purposes. See United States v. Michigan, 471 F. Supp. 192 (W.D. Mich. 1979), modified, 653 F.2d 277 (6th Cir. 1981), cert. denied, 454 U.S. 1124 (1981); Menominee Tribe of Indians v. United States, 391 U.S. 404, 405-6 (1968); People v. LeBlanc, 248 N.W.2d 199 (Mich. 1976).

For the Chippewa, fishing was central to their way of life: "The Chippewa . . . devote most of their time in quest of food in the chase or in fishing." LeBlanc, 248 N.W.2d at 204 (quoting 1836 report of Michigan Acting Superintendent for Indian Affairs). Moreover, the role of the commercial fishery

^{1/} See, e.g., Treaty With The Chippewa of June 16, 1820, 7 Stat. 206 (1820); Treaty With the Ottawa, Etc., of March 28, 1836; 7 Stat. 491 (1836); and Treaty With The Ottawa and Chippewa of July 31, 1855, 11 Stat. 621 (1855).

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to the Chippewa was well known and recognized in 1836. 2/
Article Fourth of the 1836 Treaty provided:

In consideration of the foregoing cessions,
the United States engage to pay to the
Ottawa and Chippewa Nations, the following
sums, namely . . . 6th . . . one hundred
barrels of salt, and five hundred fish
barrels, annually, for twenty years.

7 Stat. 492, quoted in LeBlanc, 248 N.W.2d at 204.

Taken together, the commercial and subsistence fishing rights reserved to the Chippewa in the 1836 Treaty guaranteed a "livelihood" in perpetuity. That livelihood is diminished when monies obtained from the sale of fish are not available to the fishermen because of a tax, whether by the federal or state government. Such a diminution or abrogation of the essential rights and purposes of a treaty must be done only by express Congressional act. See, e.g., United States v. Dion, 476 U.S. _____, 90 L.Ed. 767 (1986).

Fundamental Principles of Federal Indian
Law Prohibit the Imposition of a Federal Income
Tax on Income Derived from a Treaty or Statutory-Based
Right Absent Express Consent from Congress

In 1836 the State of Michigan did not exist. Michigan was part of the vast Northwest Territories. No territorial tax existed at that time, nor was one ever imposed before Michigan became a state in 1842. The United States Congress had not yet created a federal income tax, nor would it do so until 1939, over a century later.

Thus, there is no doubt that the parties to the 1836 Treaty never contemplated, considered, discussed or agreed to a diminution of or infringement upon the reserved commercial or subsistence fishing rights of the Chippewa and Ottawa Indians by the imposition of any tax by any taxing authority, whether federal, state or local. Because of the inequitable bargaining situation, Indian treaties have been interpreted as the Indians would have understood them, Jones v. Meehan, 175 U.S. 1, 10-11 (1899), and ambiguities must be resolved in favor of the Indians. McClanahan v. Arizona State Tax Commission, 411 U.S. 164, 174 (1973); LeBlanc, supra, 248 N.W.2d at 204.

The position of the Internal Revenue Service is that Congress intended by the enactment of the 1939 Internal Revenue

2/ The importance of commercial fishing in this area at the time of the Treaty of 1836 is well-described in a letter from Henry Schoolcraft, author of Personal Memoirs of a Residence of Thirty Years with the Indian Tribes . . . A.D. 1812 to A.D. 1842:

The number of fishing stations about the coast is numerous, and the points where fish are taken are annually increasing, under the incipient enterprise of the inhabitants. It would be difficult to estimate the present value of this trade to commerce. Several thousands of barrels of fish are up annually. One thousand barrels were brought from Lake Superior to the present season. The waters of this lake are probably destined to yield an exhaustless supply of this article. Twenty thousand dollars worth of fish may be expected to be barreled in the upper lakes the present year.

Quoted in LeBlanc, 248 N.W.2d at 204-5, n. 5.

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Code for an Indian's treaty fishing income to be taxed as the income of any ordinary citizen of the United States.^{3/} But special rules apply to Indians when engaged in treaty-based, income-producing activities. As the United States Supreme Court has noted:

While in general tax exemptions are not to be presumed and statutes conferring them are to be strictly construed, . . . the contrary is the rule to be applied to tax exemptions secured to the Indians by agreement between them and the National government.

Carpenter v. Shaw, 280 U.S. 363, 366 (1930).

And in the seminal Indian tax case of Squire v. Capoeman, 351 U.S. 1 (1956), the Court refused to impute to Congress an intent to tax an Indian in frustration of his federal treaty or statutory right:

It is unreasonable to infer that, in enacting the income tax law, Congress intended to limit or undermine the Government's undertaking. To tax respondent under these circumstances would be 'at the least, a sorry breach of faith with these Indians.'

351 U.S. at 10. ^{4/}

Most recently, the Court has articulated the standard for taxation of Indians as follows:

Indeed, the Court has held that although tax exemptions are generally to be construed narrowly, in 'the Government's dealings with the Indians the rule is exactly the contrary. The construction, instead of being strict, is liberal. . . '

Montana v. Blackfeet Tribe of Indians, 471 U.S. 759, n. 4 (1985), quoting Choate v. Trapp, 224 U.S. 665, 675 (1912).

We wholeheartedly endorse H.R. 2792 because it corrects the misguided interpretation by the IRS and the Departments of Treasury and Justice and upholds the proper interpretation made by the Department of Interior. We do not believe that previous Congresses intended for the legal rights of treaty Indians to be diminished in such cavalier fashion.

The Imposition of a Federal Tax Upon
Treaty Fishing Income Violates The Federal
Government Trust Responsibility to Indian People

Indian treaties are essentially contracts between two sovereign nations. Treaties are "not a grant of rights to the

^{3/} See §§ 11 and 22(a) of the Internal Revenue Code of 1939, 52 Stat. 452, 457 (May 28, 1938).

^{4/} The spirit of Capoeman, . . . holds that the language of the federal income tax law, broad as it is, does not extend to trust land income of noncompetent Indians even though there is no 'definitely expressed' exemption in the tax law.

Big Eagle v. United States, 300 F.2d 765, 771 (Ct. Cl. 1962).

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Indians, but a grant of rights from them -- a reservation of those not granted." United States v. Winans, 198 U.S. 371, 381 (1905). In consideration for the rights granted, the United States has a solemn obligation to protect Indian rights, in this instance fishing rights, from diminution by any source whatsoever. See, e.g., Washington v. Washington State Commercial Passenger Fishing Vessel Association, 443 U.S. 658, 667 (1979). This obligation has been characterized as deriving from the federal trust relationship between the United States and Indian tribes. United States v. Mitchell, 463 U.S. 206 (1983); No Oilport! v. Carter, 520 F. Supp. 334, 373 (W.D. Wash. 1981).

Under this trust relationship, an Indian tribe is "entitled to rely on the United States, its guardian, for needed protection of its interests." United States v. Creek Nation, 295 U.S. 103, 110 (1935). The duties imposed by the trust relationship apply to all federal agencies, including the IRS, when they are dealing with Indian property interests. Seminole Nation v. United States, 316 U.S. 286 (1942); Nance v. Environmental Protection Agency, 645 F.2d 701, 711 (9th Cir. 1981).

Thus, the Commissioner of Internal Revenue has a duty to refrain from engaging in any activity related to the taxation of Indian fishing income. Such activities expressly breach the solemn trust made to the Chippewa and Ottawa over 150 years ago.

The Imposition of a Federal Income Tax Works a Hardship on Michigan Indian Fishermen, Most of Whom Subsist on Meager Incomes Derived From Treaty Fishing

The enactment of H.R. 2792 will have little, if any, measurable impact on the federal treasury. From a practical standpoint, the vast majority of Michigan Indian fishermen earn very small incomes from the commercial sale of fish. The IRS's efforts in the last few years to collect taxes on these Indian fishermen have hardly been worth the effort, especially when compared to the federal government's cost to litigate these cases.

A 1984 study done in connection with the United States v. Michigan litigation illustrates the small income associated with this industry. In the study, entitled An Assessment of the Economic Conditions of the Bay Mills Indian Community, Sault St. Marie Tribe of Chippewa Indians, and Grand Traverse Band of Ottawa and Chippewa Indians, and a Cost-Return Analysis of Treaty Commercial Fishermen - 1981, Drs. Charles Cleland and Richard Bishop, of Michigan State University and the University of Wisconsin, respectively, conducted an economic analysis survey of 102 Michigan treaty fishermen, using 1981 data. Fifty of those fishermen earned a gross income of less than \$10,000 and lost an average of \$1,700. Another 36 fishermen grossed between \$10,000 and \$40,000, and on the average only netted \$7,200. Only five fishermen in the survey grossed more than \$100,000 in 1981, and their average net income was \$39,000.

Therefore, looking at gross income alone is misleading. After considering the costs and expenses associated with fishing - based on pure economics alone - the federal tax works a hardship on these Indian fishermen.

In sum, in the instance of our clients in Michigan, we are dealing with a very small commercial fishery in an economically depressed part of our country. In the long term, any economic benefits accruing to the federal government by these taxes will in all probability be negated if these

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fishermen, unable to continue fishing, are forced onto federal public assistance.

What this legislation represents is a clarification of treaty obligations, not special interest tax exemptions. The Department of Interior has correctly interpreted the federal responsibility on this matter. We urge the Committee on Ways and Means to likewise concur.

In closing, thank you for your attention to these remarks.

Mr. ANDREWS. Thank you very much, Ms. Roessel.

Mr. Morisset, did you have a statement you would like to give the committee?

**STATEMENT OF MASON D. MORISSET, COUNSEL, MAKAH AND
TULALIP INDIAN TRIBES**

Mr. MORISSET. Chairman Andrews, I have submitted a written statement and would ask that it be included in the record. I will not repeat any of that statement at this time.

I would like to simply address two issues you raised with Congressman Lowry, if I may. In our testimony, we have presented what we feel is the understanding of this legislation.

First, I wish to clarify that it is our understanding that when the verbal phrase "to fish" is used, that phrase means fishing activity in the broadest sense. We understand it to include buying, selling, re-selling fish or fish products to a fish processor, warehouse, trader, exporter, retailer or ultimate consumer when that activity is undertaken by an Indian or Indian tribe. You specifically mentioned canning and selling to consumers. We do understand that "fishing activity" includes those concepts.

Second, you ask questions which indicated some concerns about who it is that would be within the protected class. Again, in our written testimony, we have referenced that we understand the term Indian to include a duly enrolled member of an Indian tribe or any corporation, partnership or business entity 100-percent owned by such Indians.

The legislation also applies to income earned by an Indian tribe, where such tribe is a federally recognized Indian tribe with fishing rights secured by treaty, Executive order, or act of the Congress, including any business entity such as a corporation, partnership, or joint venture which is 100-percent owned by such a protected Indian tribe.

I just wanted to clarify that, Mr. Congressman, thank you.

[The statement of Mr. Morisset follows:]

TESTIMONY OF MASON D. MORISSET, ESQ.
 PIRTLE, MORISSET, SCHLOSSER & AYER, ATTORNEYS AT LAW
 SEATTLE AND WASHINGTON, D.C.
 BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
 IN SUPPORT OF H.R. 2792

December 14, 1987

My name is Mason D. Morisset. I am a partner in the law firm of Pirtle, Morisset, Schlosser & Ayer of Seattle and Washington, D.C. I am here on behalf of the Northwest tribes appearing before you today. I have been privileged to serve as counsel to many of them in treaty fishing rights litigation. Our firm also represents tribes throughout the nation in a broad spectrum of taxation matters. It is both from the Northwest perspective and a broader perspective that I speak today.

Mr. Chairman and Committee members, I appreciate the chance to appear before you today in support of H.R. 2792 concerning the taxation of income derived from the exercise of federally protected fishing rights by American Indians.

As I stated, it has been my privilege to represent Indian tribes and individual Indians as legal counsel in fishing and taxation litigation throughout the country. In these endeavors one message has always been loud and clear: The Indians fervently believe that promises made to them by the Government through treaties, congressional acts, and executive orders preserving their fishing rights included the promise that the government would not tax the exercise of that right.

Despite universal belief that such an assurance was implied in governmental recognition of their rights, the Internal Revenue Service has, in recent years, accelerated attempts to tax the exercise of these rights. In my view this is a direct contradiction of promises made in treaties, executive orders and congressional acts. It is to set the record straight that H.R. 2792 has been introduced.

1. Fishing Rights Were Preserved by Treaty, Act of Congress and Executive Order

At the outset we should note that Government assurances preserving fishing rights have come in many forms. One of the most familiar forms is by treaty between the United States Government and the governing chiefs of the various tribes and bands. However, the factual pattern of promises made throughout our nation is somewhat more complex. In many instances documents designated as "treaties" were signed with chiefs and headmen only never to be formally ratified by the Senate either through inaction or inattention or due to technical changes in the law. Thus, promises were made to tribes concerning their fishing rights which were ultimately recognized through one of three mechanisms: a formal treaty, an act of Congress, or an executive order setting aside a reservation for a particular tribe or tribes. Therefore, any legislation which addresses this problem should include the recognition of this historical fact.

2. Fishing Rights Are to Be Freely Exercised

The treaties, statutes, and executive orders that we are concerned with have been construed to protect fishing rights of tribes. The courts have made it clear that those rights are to be free from governmental interference save for two instances; namely, regulation to meet conservation needs and regulation to achieve a proper allocation of the harvestable resource. See, e.g., Washington v. Passenger Fishing Vessel Association, 443 U.S. 658 (1979).

Additionally, the courts have recognized the importance of the fishing right and that the tribes did not grant the power to tax treaty rights. Mason v. Sams, 5 F. 255 (W.D. Wash. 1955). And certainly state attempts to tax treaty fishing rights by imposing a tax and license fee upon tribal members were opposed by the United States and were struck down by the Supreme Court as an impermissible infringement upon treaty secured rights. Tulee v. Washington, 315 U.S. 681 (1941).

We think it clear that the understanding of the Indians who negotiated the treaties must govern their meaning. The Supreme Court has ruled on this many times, most recently in the appeal of the fisheries decisions dealing with Northwest treaty tribes. There the court held that the understanding of the Indians must control.

[This court] has held that the United States, as the party with the presumptively superior negotiating skills and superior knowledge of the language in which the treaty is recorded, has a responsibility to avoid taking advantage of the other side. [T]he treaty must therefore be construed, not according to the technical meaning of its words to learned lawyers, but in the sense in which they would naturally be understood by the Indians.

Washington v. Passenger Fishing Vessel Association, 443 U.S. 658, 675-76 (1979).

3. Recognition of Exemption by the Government.

The courts of the United States and the Executive Branch early recognized that general laws of the United States should not apply to Indians unless Congress made a specific reference to such application. Thus, in Elk v. Wilkins, 112 U.S. 94 (1884) the Court stated:

General acts of Congress did not apply to Indians, unless so expressed as to clearly manifest an intention to include them.

In 1912, in the case of Choate v. Trapp, 224 U.S. 665 (1912), after stating the general rule that exemptions from taxation are to be strictly construed, the Supreme Court nevertheless noted:

But in the government's dealings with the Indians the rule is exactly the contrary. The construction, instead of being strict, is liberal; doubtful expressions, instead of being resolved in favor of the United States, are to be resolved in favor of a weak and defenseless people, who are wards of the nation, and dependent wholly upon its protection and good faith. This rule of construction has been recognized, without exception, for more than 100 years and has been applied in tax cases.

Early opinions of the United States Attorney General also held these views. After quoting the language noted above from Elk v. Wilkins, the Attorney General noted in a 1924 opinion:

The Indian has always been the object of special legislation. Never has it been the practice to legislate for him generally along with the rest of the people. 34 Ops. Atty. Gen. 439 (1924).

And again in 1925 the Attorney General noted:

The principle was emphasized that general acts of Congress do not apply to Indians unless so worded as to manifest a clear intention to include them; that

Indians have always been the object of special legislation, and that general legislation, and especially revenue laws, which burden and restrict the use and enjoyment of property, should not be applied to Indians, unless Congress in clear and unambiguous language so directs. 35 Ops. Atty. Gen. 1 (1925).

From these expressions it is clear that the courts and administrative agencies of the government were of the opinion that tax laws should not generally apply to Indians, particularly in the face of treaties reserving certain rights to those Indians. Nevertheless, the Internal Revenue Service has chosen to accelerate its efforts to exact income taxes from treaty reserved fishing rights in contravention of these rules.

4. Court Consideration of Fishing Income

In the case of fishing no federal court other than the tax court has ever clearly addressed this issue. In 1946 the tax court held fishing income from a Quinault Indian fishing on the reservation to be taxable. "Charles Strom," 6 T.C. 621 (1946). This was affirmed per curiam by the Ninth Circuit without any significant independent analysis. Strom v. Commissioner, 158 F.2d 520 (9th Cir. 1947).

Not until recent times was there any significant activity in the area of taxation of reserved fishing rights. Then in 1982, in the case of Earl v. Commissioner, 70 T.C. 1014 (1982), the tax court held that income of a Puyallup Indian gained from working as a cook on a non-Indian vessel was taxable as treaty fishing income. This case continues to be cited as precedent by the tax courts and by the Internal Revenue Service. This is an example of the lengths to which the IRS will go to continue its attempts to tax Indians. Earl is not even clearly a treaty fishing rights income case since the taxpayer was working as a cook on a non-Indian vessel which was fishing outside the usual and accustomed fishing places of his tribe. Secondly, Earl was not represented by counsel. Despite the fact that the taxpayer appeared pro se and there was very little analysis of the treaty fishing right, the tax court used the opportunity to attempt to establish a binding precedent, and the IRS has been only too willing to accept the case in that light.

5. Interference with Tribal Government

One important aspect of treaty fishing rights cases is the recognition of tribal self-government. In my view, federal taxation of fishing activity runs directly counter to the needs of tribal self-government.

In the United States v. Washington, 384 F. Supp. 312 (W.D. Wash. 1974) the Federal District Court recognized the self-governing aspects of Indian tribes and charged them with substantial authority and responsibility to manage the fisheries resource and harvest by tribal fishermen. Thus, for example, a comprehensive fisheries management plan has been adopted by the court which requires the tribes to carry out governmental fisheries regulatory and management functions. 459 F. Supp. 1020, 1107 (1978). While receiving some assistance to carry out these functions, many tribes also tax fishing activity to help support the infrastructure necessary to carry out their responsibilities. Clearly taxation by the Federal Government places an additional burden on the fishermen which they can ill afford.

6. Revenue and Enforcement.

One would be remiss not to discuss briefly the revenue gained for the Treasury and the enforcement problems created by attempts to tax the treaty fishing right. Suffice it to say that the revenue level is very small and the enforcement problems very

high. While it is not possible to accurately estimate the amount of tax revenue which would be generated by full taxation of treaty fishing right income, it is most certainly not more than a few hundred thousand dollars by any estimation, and it may be substantially less.

On the other hand, compliance problems would be substantial. Fishing is a complex business involving capital outlay and high expenses. Due to the intense depth of feeling for the treaty right, many tribal members would be unwilling to engage in the onerous record-keeping and reporting requirements that might be necessary. The result would be a great deal of time, effort and money spent in pursuing very little if any meaningful revenue.

7. Statutory Language

We want to stress the importance of and the need for legislation to be precise enough to clearly direct the Internal Revenue Service. We cannot count on the Service to give the benefit of the doubt to Indian tribes or tribal members. This is well illustrated by a private letter ruling in 1982 by the Service that income earned from the sale of fish grown on a trout farm on individual trust land was not "directly derived from the land and thus was taxable as ordinary income." Despite the clear ruling of Squire v. Capoeman, 351 U.S. 1 (1956), and derivative cases as to the non-taxability of crops grown on trust land, and the clear analogy from that to fish grown in "trust water," the Service was unwilling to extend the reasoning of Squire v. Capoeman to the fishing situation. Thus, we think it clear that no loopholes must be left for the IRS to use in its quest to tax the fishing right.

It is our understanding that the legislation is to be construed as follows:

(1) The term "Indian" includes a duly enrolled member of an Indian Tribe, and any corporation, partnership or other business entity one hundred percent (100%) owned by such Indian.

Many tribal lawyers, including our firm, have encouraged tribal members to use modern business mechanisms where possible. We do not want to have arguments with IRS in the future over the precise way that a tribal member may be exercising his treaty fishing right.

(2) The legislation covers all "fishing activity" and the term "fishing activity" includes the harvest or capture, by net, hook, spear, traps or weirs of fish, including assisting another Indian in such activity, where such fishing activity takes place within the exterior boundaries of a federally recognized Indian reservation or at usual and accustomed places within or without an Indian reservation where fishing rights are guaranteed by treaty, executive order or congressional action.

(3) The terms "fishing activity" also includes buying, selling and re-selling fish or fish products to a processor, warehouse, trader, exporter, retailer or ultimate consumer when such activity is undertaken by an Indian or Indian tribe.

(4) The terms "usual and accustomed places" includes all places, grounds, stations, sites and locations secured to Indians by treaty, executive order or congressional act for the benefit of Indians.

(5) The term "assisting" includes an Indian working as a crew member on a boat or vessel owned by an Indian or Indian Tribe, and working as an employee of an Indian or Indian Tribe when engaged in a fishing activity.

(6) The term "Indian Tribe" means federally recognized

Indian Tribe with fishing rights secured by treaty, executive order or congressional act, and includes business entities such as corporations, partnerships and joint ventures one hundred percent (100%) owned by such tribes.

(7) The legislation applies retroactively.

(8) Further, we believe that the Internal Revenue Service should be required officially to notify affected Tribal Governments and the congressional committees responsible for American Indian issues, if the income of American Indian Tribal members derived from a resource secured by treaty, executive order or congressional act is under consideration for federal taxation.

8. The Precedent for Congressional Clarification

Finally, we note that this is not the first time that it has been necessary to ask the Congress to clarify the protected nature of reserved tribal rights. In the case of distributions of tribal income from tribal assets distributed per capita to tribal members, the Internal Revenue Service decided in Revenue Ruling 67-284 that such tribal income would be includible in the gross income of an Indian tribal member when distributed to him. It was necessary for the Congress to set this matter straight in Pub. L. 98-64 (1983). That act of Congress made it clear that where funds are held in trust by the Secretary of the Interior for an Indian tribe, and those funds are distributed per capita to tribal members, then the per capita distributions will be treated as tax exempt upon distribution. This should have been clear to the IRS but required a congressional directive to make it so. It appears that once again, we must ask Congress to clarify matters.

Thank you, Mr. Chairman. I would be glad to answer any questions you may have.

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Mr. ANDREWS. Thank you very much.

Mr. Flippo.

Mr. FLIPPO. I have no questions. I just wanted to thank the witnesses. I think you have expressed yourself extremely well and to the point.

Mr. ANDREWS. Mr. Morisset, two quick questions. Give me your thoughts please, if a corporation or a partnership is involved in commercial fishing. What is the effect of this legislation?

Mr. MORISSET. As to the question of a partnership, as you know, the tax consequences are passed through to the members of the partnership, and there is no tax consequence to the partnership as an entity. If the partners were Indians as I just defined them, and if they were members of a tribe which has rights as I have defined them in my written statement, then that income would not be taxable. If they are not within that protected class, in that either their tribe has no treaty or no defined rights, or they are not members of such a tribe, or they are fishing somewhere they should not be, then they would not be within the protected class and their income would be subject to normal tax laws.

As to a corporation, for reasons having to do with the application of State law and other laws, very few Indians incorporate under State law. But if they were to do so, and that corporation were 100 percent owned by Indians, it is our understanding that the corporation's income would be protected from taxation.

Mr. ANDREWS. Suppose the corporation or partnership engaged in fishing and other businesses?

Mr. MORISSET. Then you would have the same kind of problems that we have in other fields of tax law. There would have to be an accounting and a tracing of the source of the income to determine taxability.

Mr. ANDREWS. One more question. If their income is exempt, your clients will not receive Social Security benefits. Is this acceptable to your clients?

Mr. MORISSET. It is my understanding from what the chairman of the Northwest Fish Commission has stated and my understanding from knowledge of the tribal fishermen, that most of them understand that connection and that they are of the opinion that the treaty right is to be free from all taxation. If they wish to step into other jobs to pick up those kinds of benefits which are dependent upon taxes being paid, then some of them may choose to do so.

Mr. ANDREWS. I want to thank each and every one of you for coming this afternoon. We appreciate your testimony, and I promise you, the Ways and Means Committee will study it carefully. Thank you very much for your attention and your time.

[The following was subsequently received:]

RESPONSIVE COMMENTS OF MASON D. MORISSET, ESQ.
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Before the Subcommittee on Select Revenue Measures
in Support of H.R. 2792

December 22, 1987

These comments are made in response to the statement of C. Eugene Steuerle, Deputy Secretary (Tax Analysis), Department of the Treasury, submitted to the Subcommittee on Select Revenue Measures on December 14, 1987. They are in addition to testimony I presented on that date to the Subcommittee.

1. Application of H.R. 2792 to Pending Litigation.

It is our understanding that this bill does apply to all pending litigation concerning taxation of income from treaty fishing operations and that it would render all such litigation moot.

2. Application of H.R. 2792 to FICA and FUTA Taxes.

It is our understanding that no taxes, including FICA and FUTA taxes, would be applied to income derived from treaty fishing operations as a result of this legislation.

3. The Allocation Between Fishing and Non-Fishing Income.

Treasury's December 14 statement indicated a concern that H.R. 2792 "may require potentially burdensome allocations between fishing and non-fishing income in order to determine the proper amount of taxable income from activities that remain fully taxable under the bill." The allocation between fishing and non-fishing income that might be required is no more burdensome than allocation between other kinds of income normally required on a tax return. Fishing operations of most individuals are usually distinct enough in time and nature to allow easy allocation. Income and expenses related to fishing operations are generally not commingled with other business operations, and we do not believe that this problem would in any way be "potentially burdensome."

4. Purported "Uneven Taxation".

Treasury's statement of December 14, 1987, also opined that issues of tax policy were raised since H.R. 2792 "would result in uneven taxation of Indians who exercise fishing rights and Indians or other individuals who derive income from non-exempt activities." The issue presented by H.R. 2792 is the understanding and intent of treaties by which Indians surrendered vast tracts of lands and other rights in return for certain retained rights. It is not "uneven" to tax income from non-exempt activities where there was no intent nor understanding that such activities were to be a protected treaty activity.

5. Other provisions in the tax law already serve to exempt low income persons from taxation. Treasury's statement of December 14, 1987, also indicated some concern over tax policy in that certain other provisions (e.g. earned income tax credit, personal

exemption, etc.) already serve to exempt low income persons from taxation. This criticism of the proposed legislation simply misses the point. The exemption and clarification is not sought as a matter of tax policy nor social benefit to low income persons. Rather the tribes seek to have the promises, understandings and intent of the treaties clarified and their understanding that the fishing rights guaranteed in those treaties would include exemption from income tax sustained.

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Mr. FLIPPO [presiding]. As next witness, we are pleased to have with us today from the Department of State, Ambassador Vernon Walters. It is a pleasure to see you, sir. We are pleased to have you with us today, and you are here on a very important matter. A man of your character and experience, I am sure can negotiate a very acceptable position, I am certain of that.

And we are just delighted to have your testimony today on a very important matter concerning the taxation of housing benefits for individuals employed by or assigned to the U.S. mission to the United Nations. Your statement will, of course, be included in its entirety in the record. Please proceed as you deem appropriate.

STATEMENT OF HON. VERNON A. WALTERS, U.S. PERMANENT REPRESENTATIVE TO THE UNITED NATIONS, U.S. DEPARTMENT OF STATE

Ambassador WALTERS. Mr. Chairman, thank you. We have submitted the written testimony to you. I do not know whether you want me to read it or not. I would be glad to, but you have it available to you. And in the interest of saving time, I might just perhaps make a few additional remarks concerning it.

Mr. FLIPPO. Very good.

Ambassador WALTERS. This program, Mr. Chairman, came into existence in its first form in 1972 when it was found extremely difficult to recruit people to go to New York because of the high cost of living there. The Foreign Service officers who were going there were competing for overseas posts where they would have housing.

In 1972, the original housing allowance program was started. In addition, in 1983 Ambassador Kirkpatrick asked for and obtained authorization for a Government lease program that covers 50 people out of a mission of 120, 125. These are people that are required to be on call. We have sessions, morning, noon, night, et cetera.

The biggest problem which all of my predecessors found was the difficulty in recruiting people to go to New York because, as I say, they are mostly Foreign Service people—not all, by any means—who are looking to go to some foreign place where they would get this kind of housing.

The problem arises from the fact that the 1972 and 1983 amendments did not mention taxation. The State Department subsequently issued regulations which stated that the housing allowance and Government-leased program were tax-exempt. And many people went there in the belief that it was. Now in a recent State review of taxable benefits, it was found that the U.S. U.N. was not covered by existing Tax Code regulations.

It is an anomalous situation. I have the only U.S. Embassy in the United States. All the others are abroad. And I do not deal fundamentally with the U.S. Government except as its representative. I deal with 158 other governments. My people basically do exactly the same kind of work that they would be doing if they were in Paris, Tokyo, or Buenos Aires, diplomatic, economic, and so forth.

So, we were finally able to recruit people because we had what we thought was this tax-free housing program such as State Department people get in other embassies around the world. Now the

problem is that, if this program is taxed, we negate the purpose of the program, which is enabling people that are qualified to come up there and live in this very costly housing environment.

Now I know they say, then every U.S. Government agency should do this. But it is a little bit different in which these employees are actually doing the same diplomatic work they would be doing if they were assigned to any other embassy. Because of this tax situation and the uncertainty surrounding it, their liability is increasing daily. And it is the single largest morale problem I have.

And the odd part is that I am not covered by this, I am not liable. And I am far better able to pay this tax than they are. And that makes it all the more aggravating and a morale problem because here I am living in the Waldorf Astoria, in a house in which all my predecessors have lived for the last 40-some years, which we are still renting, which I think we could have probably bought the Waldorf Astoria with the money we have paid them in the last 40-some years.

So this makes it a real morale problem for me, that I, as the highest salaried member there, am receiving tax-free housing, and they, who earn a great deal less than I do, are not. If this taxation goes on retroactively, it may cost them their savings to pay this retroactive tax.

I am hopeful that working with Treasury, with OMB, and obviously with the Congress who determines it, ultimately we will be able to work out some program that will maintain the equity of this and enable these people to live without practically the shadow of the sword of Damocles which has been hanging on them ever since they decided it was not. Because they went there in good faith. They were assured by the Department that this was a tax-free benefit, and that is the way the State Department regulations described it.

And as I strive to handle problems of the Middle East, handle the Gulf War and everything else, here I am on my southern front. As a matter of fact, just about right now I should be at my Christmas party for my staff. But I am sure they will forgive me if they know what I am doing here.

All we are trying to do is find some way that will confirm what I believe to have been the original intent of the law. Namely, that it was a benefit that would enable them to withstand the higher cost of housing in New York. And I believe that when this program was started in 1972 and expanded in 1983, New York had not reached parity with Tokyo as the most expensive city in the world.

I am a born New Yorker, and I know to recruit me—and I went into the Army, into Government service as a young soldier in 1941, people have asked me ever since, would you like to go back to New York. And I said, only if I had a decent place to live and a driver to take care of the parking problem. And it took me 44 years, but I finally did it.

But I am concerned with these younger people who are facing a very difficult situation, Mr. Chairman. The details of this, the history of it are in the written statement that I have submitted. And I would be prepared to try and answer any questions you might have concerning this.

[The statement of Ambassador Walters follows:]

TESTIMONY OF

THE HONORABLE VERNON A. WALTERS
U.S. PERMANENT REPRESENTATIVE TO THE UNITED NATIONS

BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

December 14, 1987

Mr. Chairman and Members of the Subcommittee:

I would like to thank you for inviting me to appear before you today on the issue of the taxability of housing benefits received by U.S. Government employees assigned to the United States Mission to the United Nations. We appreciate your willingness to hear us on this issue on such short notice.

I must reluctantly tell the Committee that because of the somewhat unusual way in which this taxation issue arose at this time, we are in the uneasy posture of knowing that we have a problem, but of not yet having a proposed solution which has been cleared through the Administration. As Mr. Steuerle, Treasury's Deputy Assistant Secretary for Tax Policy, indicated to you this morning, our plan is to work closely with the Treasury Department and with the Office of Management and Budget to develop such a proposal, which we would hope to be in a position to discuss early in the next session.

In reviewing the applicability of the Internal Revenue Service regulations implementing provisions of the Tax Reform Act of 1984 relating to the taxation of fringe benefits, the Department became concerned that the tax exempt status of various housing benefits received by USG employees pursuant to sections 8 and 9 of the United Nations Participation Act of 1945 was not entirely clear.

The Department of State administers two types of housing programs for certain employees assigned temporarily to the U.S. Mission to the United Nations in New York City. The housing allowance program, which has been in effect since 1972, provides a cash housing supplement; four individuals are currently receiving this supplement. Under the leasing program, in effect since 1983, USUN leases housing quarters for eligible employees. About forty employees are currently provided housing under this part of the program.

Since the inception of the allowance program fifteen years ago, there has been a general understanding that these benefits were tax-free to the employee. The entire program has been structured on this premise and has been so represented to prospective applicants for positions at USUN. Indeed, the Standardized Regulations, which govern benefits and allowances received by USG employees overseas, incorporate regulations on the UN housing supplement in chapter 100. Section 054 of the Standardized Regulations specifically states that "allowances authorized and paid in accordance with chapter 100...shall not be included in gross income for Federal income tax purposes."

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As you know, Government employees stationed abroad are generally permitted to exclude from gross income certain housing and other allowances under section 912 of the Internal Revenue Code. The United Nations Participation Act is not, however, specifically referred to in section 912, nor does the UN Participation Act, which authorizes these benefits, expressly provide for their tax-free status.

Employees temporarily assigned to USUN are thus in a less clear position than similarly situated employees assigned to posts abroad. Since neither the regulations nor Department practice has raised this potential problem, the affected employees have for the past fifteen years relied upon the tax-free financial assumption in accepting these demanding USUN positions. We thus believe it is critical to clarify the tax position of these individuals with respect to receipt of past benefits. We do not wish to be in a position where employees assigned to this Mission fear that they could potentially face past tax liabilities so substantial that they would have to exhaust their savings accounts.

The Department of State assigns Foreign Service officers to most of the substantive positions at our Mission to the United Nations, where they assume responsibilities similar to those held on assignments abroad. They work with the diplomatic personnel of other nations, interact with the U.N. Secretariat much as they would with a host government's foreign ministry, and represent the United States in policy debates and at official functions. The Department assigns to our Mission to the United Nations Foreign Service officers with broad overseas experience in political and economic affairs and Embassy management. Before the introduction of the USUN housing program, the Department faced a severe problem in locating qualified personnel for assignment to New York: without the type of housing supplement provided at posts abroad, they simply could not afford to live there.

We thus believe that a supplemental housing program is critical to USG interests in attracting the best qualified individuals to represent the United States to the 158 countries at the UN. The Congress has supported this view in enacting this program. The legislative history, too, reflects congressional concern that the program is necessary to eliminate substantial, personal, out-of-pocket expenses and ensure that economic hardship does not adversely affect our ability to attract the best qualified individuals for service at this important U.S. Mission.

Non-taxability has been assumed to be a key part of the economics of this program. We believe that housing benefits received at USUN must be as clearly tax-exempt as benefits received by similarly situated foreign affairs specialists when they accept a posting abroad. Otherwise, USUN would be at a serious disadvantage in attracting the quality officers it needs to do the job. Such a result is also consistent with the longstanding rationale for the tax-free status of housing benefits at overseas posts. Allowances are necessary to meet the extra cost of living at individual posts, and since the Department has neither the funds nor the authority to increase the allowances enough to offset the tax on them, tax exemption is the appropriate approach.

In conclusion, let me thank you again for providing us with this opportunity to contribute our views for your consideration. I would be happy to respond to any questions which you might have.

Mr. FLIPPO. Thank you very much, Mr. Ambassador. I might just ask you, that in Washington we have a relatively high cost of living. Certainly housing is far beyond the cost of average housing in the United States. Do you think that State Department employees in Washington should also get some type of tax-free housing allowance?

Ambassador WALTERS. I would not know. When I worked here, I did not get a housing allowance, nor did I get any of the facilities I described previously, and I was able to live here. I would estimate right now, by virtue of the fact that I am living in New York City, I am spending \$1,000 a month, even with the housing furnished, more than I did when I was here.

It is a question of justice. Obviously, you would like to see everybody get it. As I say, I have this anomaly of the only U.S. Embassy in the world physically located in the United States. And my principal problem—not my problem, I will only be there another year if I stay the full term—is recruiting good people.

The President said to me, go there, do not wreck it, reform it. We have gotten a wide measure of reform. We have gotten a whole set of the objectives that I was given. And I would just like to, when I leave there, make sure that there is a first-class staff there.

Mr. FLIPPO. Mr. Ambassador, I think you make some outstanding points. We really should settle this issue. And it looks like we have a couple of problems; potential past liability, and what are we going to do about the future. And your statement clearly indicates you are working with IRS trying to find a reasonable solution, and I am hopeful that we can find a reasonable solution.

We in the Congress are faced with some of the same kind of problems. And perhaps we can find a generic solution that will solve everyone's problems and make it a lot more reasonable. Speaking for one member, I think you have done an outstanding job there. We are delighted to have your testimony today.

Are there further questions?

[No response.]

Mr. FLIPPO. Thank you very much for showing up here today and missing your Christmas party.

Ambassador WALTERS. As I say, I am an old soldier and I know that loyalty goes down as well as up. And I feel, as I say, a strong sense of loyalty to my people who are not getting what I am, and that embarrasses me very much.

Mr. FLIPPO. Let us hope for an early resolution.

Ambassador WALTERS. Thank you very much, Mr. Chairman.

Mr. FLIPPO. Thank you very much. Appreciate it.

We have run out of witnesses, thus we can conclude the hearing.

[Whereupon, at 4:25 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

H.R. 1049.—UTILITY RATEPAYER REFUND ACT OF 1987

STATEMENT OF**SCOTT L. CAMPBELL****DIRECTOR OF THE OFFICE OF POLICY, PLANNING AND ANALYSIS
UNITED STATES DEPARTMENT OF ENERGY*****Statement on H.R. 1049,
"The Utility Ratepayer Refund Act of 1987"***

The Department of Energy opposes the "Utility Ratepayer Refund Act of 1987" (H.R. 1049). This legislation would repeal Section 203(e) of the Tax Reform Act of 1986, which requires the "normalization" of excess deferred taxes generated by the Act's reduction of the corporate tax rate. In doing so, it would dissipate the incentive which Congress intended to provide for capital investment and would thereby jeopardize the adequacy of our electric power supply.

Utilities accumulate reserves for deferred taxes which are depleted as the taxes are paid. The Tax Reform Act of 1986 reduced marginal income tax rates from 48% to 34%. Utility reserves for deferred taxes, collected under prior tax law, were greater than needed to pay taxes at the lower rate. At issue is the manner in which the excess tax reserves should be refunded to customers over time.

Under conventional accounting rules, in effect for the last two decades, the excess reserves would be distributed so that consumers receive a benefit over the full remaining lifetime of existing power plants. Under H.R. 1049, however, consumers would receive all the tax benefits in the first few years after passage. Thus, the proposed change from "normalization" to "flow through" accounting for excess deferred taxes would benefit today's consumers unfairly at the expense of tomorrow's. These excess reserves were collected not only from current consumers but also from consumers in prior years, so it is inappropriate for current consumers to reap the entire benefit of the tax reduction.

More significantly, H.R. 1049 would frustrate the intent of Congress to promote capital investment in new electrical generating facilities. Under current accounting rules, utilities enjoy immediate tax savings which are passed on to consumers gradually. With the resulting improvement in their cash flow, utilities are in better financial condition and can thus obtain debt and equity financing at a lower cost when it comes time to build power plants.

By the end of the century, the nation will need 100 gigawatts or more of new electric power supply. This is an increment of at least 15 percent beyond the generating facilities that are now in place or under construction. The cost may well be in the neighborhood of \$200 billion. If this need is to be met and electric service is to remain reliable, utilities need to be in good financial condition and have appropriate investment incentives. Thus, H.R. 1049 is inimical to the achievement of reliable electricity service at reasonable costs. For these reasons, the Department of Energy opposes this legislation.

STATEMENT
OF THE
HONORABLE CARDISS COLLINS
ON

H.R. 1049, THE "UTILITY RATEPAYER REFUND ACT OF 1987"

Mr. Chairman:

I want to commend you for holding this hearing today on H.R. 1049, the "Utility Ratepayer Refund Act of 1987."

The issue before you today can be summed up as follows: who has the greatest expertise to decide the regulatory treatment of a utility's excess deferred taxes, Congress or state regulators?

Under current law, Congress has taken upon itself to decide that utilities should return these deferred taxes over the life of the facilities for which certain tax benefits were taken. As a result of this law, and the considerable drop in corporate tax rates enacted last year, utilities now hold \$19 billion in excess taxes that will never be paid to the U.S. Treasury. In fact, of this \$19 billion, nearly \$650 million is held by utilities that serve the city of Chicago.

These are hardly inconsequential sums! Given the importance of this issue to the pocketbooks of ratepayers, as well as the financial interests of utilities, it is not a matter that should be decided arbitrarily by Congress.

Instead, this is an issue that should be evaluated on a case-by-case by state regulators. Each utility has a unique financial situation and specific capital requirements. While many are "cash cows" today, a few need serious infusions of capital. Most utilities have also completed their major construction programs for the immediate future; however, some need to build new facilities to meet increasing demand for their services. Congress is not the place to balance these considerations against the pocketbook interests of ratepayers. Again, the ones best able to do this balancing are state regulators.

Opponents of this bill will argue, however, that this issue should be decided by Congress because it involves tax, not regulatory, policy. I disagree. From a budgetary standpoint, the Joint Committee on Taxation estimates that H.R. 1049 "will not have any significant revenue impact." Moreover, Congress made it clear in last year's Tax Reform Act that it no longer wants the tax code to influence companies' investment decisions. Yet, if utilities are allowed to retain this cash, it may allow them to make capital investments, in utility and non-utility ventures, that Congress did not intend.

H.R. 1049 will protect the financial interests of both utilities and ratepayers by giving state regulators the authority they need to weigh these important considerations. This is both sound fiscal and regulatory policy.

I urge my distinguished colleagues on the committee to give favorable consideration to this important legislation.



STATE OF CONNECTICUT

DEPARTMENT OF PUBLIC UTILITY CONTROL

December 17, 1987

The Honorable Charles B. Rangle, Chairman
 Subcommittee on Select Revenue Measures
 House Ways and Means Committee
 1102 Longworth Building
 Washington, D. C. 20515

Dear Chairman Rangle:

Subject: H.R. 1049 - UTILITY RATEPAYER REFUND ACT OF 1987

Although I was unable to attend your hearing on the above referenced Bill, I would appreciate your inclusion of my comments in the hearing record.

The Connecticut Department of Public Utility Control has spent considerable time and effort investigating the impacts of the Tax Reform Act of 1986 on Connecticut ratepayers and utility companies. Our research and analyses confirm the appropriateness of the proposed repeal of Section 203(e) of the Tax Reform Act of 1986.

Section 203(e) requires normalization of excess deferred taxes over the remaining life of the property responsible for the reserve for deferred taxes. For utilities with large deferred tax reserves attributable to plants with long remaining lives, such as in Connecticut, this method creates potential inequities between customer classes and customer generations. Additionally, Section 203(e) limits regulators' ability to minimize disruptive rate increases associated with the plants responsible for the deferred tax reserves. Such disruptions threaten utilities as well as ratepayers. The regulatory process is the proper forum for the detailed consideration of relative costs and benefits of alternative excess deferred tax refund methods, assuring equitable treatment under varying circumstances.

Along with utility regulatory agencies across the country, the Connecticut Department of Public Utility Control requires flexibility to face the challenges of changing economic, regulatory, and competitive conditions. I join the strong support for this proposal expressed by the National Association of Regulatory Utility Commissioners and other regulatory agencies.

I appreciate your consideration of my comments and please do not hesitate to contact me if I may provide further information.

Sincerely,

Peter G. Boucher
 Chairperson

One Central Park Plaza • New Britain, Connecticut 06051
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Harlem Consumer Education Council, Inc.

1959 Madison Avenue New York, N.Y. 10035 (212) 427-0300

FLORENCE M. RICE
PRESIDENT

Statement of Florence M. Rice Harlem Consumer Education Council, Inc.

The Harlem Consumer Education Council strongly supports H.R. 1049, The Utility Ratepayer Refund Act of 1987. This legislation is needed to correct a serious injustice in the new tax law.

For many years, Congress has allowed utilities to collect money for federal income taxes from ratepayers in advance. Now that Congress has reduced the tax rate, the utilities no longer owe some of these taxes to the government. Yet the federal law says the utilities get to keep this money for up to 30 years!

According to the National Association of Regulatory Utility Commissioners (NARUC), the utilities now have \$19 billion in "excess deferred taxes" which they will never pay to the government. New York Telephone, for example, owes its customers \$587 million, and Con Edison owes \$162 million!

The utilities should be ordered to refund these tax overcharges as soon as possible. But the new federal law prevents state Public Service Commissions from ordering refunds of excess deferred taxes. The law says consumers must wait up to 30 years to get a full refund.

The utilities say they need the money for their own investments. But consumers need it even worse! Besides, it's our money, not theirs. We think it's unfair for someone to collect our money and use it for their own purposes.

The current tax law is an injustice to poor people. The little money we have is needed to pay the rent, utility bills and put food on the table. We can't afford to lend money to our utilities that we won't get back until the next century!

How can the poor be expected to work their way out of poverty when the government's tax laws favor the giant corporations and the rich? The law lets the utilities take our money so they can pay their executives hundreds of thousands of dollars in salaries each year.

The current tax law is especially unfair to senior citizens, who may not live to see their refunds. We were forced to provide this money to the utilities through tax overcharges and now we may never get it back! It's also unfair to struggling small businesses which paid the overcharges but may not be around long enough to receive their fair share of the refunds.

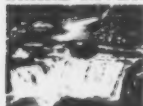
When millions of families and businesses are struggling to make ends meet, it's just outrageous that the giant utilities get to keep this money which rightfully belongs to the consumer. If NYNEX can afford to buy up new businesses all over the country, surely it can afford to refund the overcharges it collected through our phone bills!

The Harlem Consumer Education Council, Inc., joins with the New York Public Service Commission and New York State Attorney General Robert Abrams in supporting H.R. 1049. We urge the Congress to take action as soon as possible.

We feel privileged to have the opportunity to place this statement in the official hearing record for H.R. 1049.

Florence M. Rice
December 18, 1987

SNAKE RIVER



HYDRO POWER

IDAHO POWER COMPANY

BOX 78 BOISE, IDAHO 83707

DUWAYNE D. HAMMOND, JR.
Vice President and
Chief Financial Officer

December 18, 1987

Robert J. Leonard
1102 Longworth House Office Building
Washington D.C. 20515

Subject: HR 1049 Utility Rate Payer Refund Bill of 1987

Dear Sir:

Idaho Power Company is a public utility which is franchised to sell electricity in a service territory comprising of over 20,000 square miles in Southern Idaho, Eastern Oregon and Northern Nevada. Idaho Power's total assets as of December 31, 1986, exceeded 1.6 billion dollars and revenues were approximately 400 million dollars.

At December 31, 1986, Idaho Power's accumulated Federal Deferred Income tax liability on tax depreciation in excess of straight line depreciation totaled about 147 million dollars and was accumulated at a statutory federal rate of 46%. Thus, there is approximately 38 million dollars of accumulated deferred income tax reserves on Idaho Power's books that would be subject to accounting treatment under the Average Rate Assumption Method or the HR 1049 legislation.

Idaho Power opposes the HR 1049 legislation and supports continuation of the Average Rate Assumption Method contained in IRC Section 168. The reasons are as follows:

1. Federal Income Taxes paid to U.S. Treasury will fall: If a more rapid than ratable flow thru of the accumulated deferred income taxes are mandated by Congress, State Utility Commissions will be compelled to reduce rates and revenues by a factor more than the amount amortized to income. This reduction in rates will trigger reduced federal income tax collections over the shorter period. Almost 13 million dollars of federal income taxes would not be paid by Idaho Power to the IRS over the shorter period(s) provided in HR 1049. This is because deferred income taxes are not tax deductible thus they represent an amount of taxable income to the U.S. Treasury.

2. Higher utility financing costs makes measure counter productive: Cash flows to the company would be realized at lower levels over the short amortization period provided in the legislation. Accumulated deferred income taxes provide the company a source of zero cost of capital. This is an accepted standard by both the regulators and the regulated companies. A portion of that source of capital would be lost and have to be

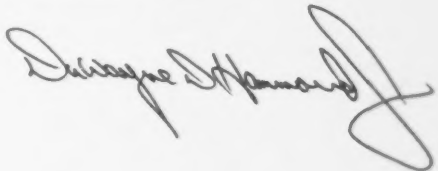
replaced with higher cost of capital thus the "rate reduction" would create a counter productive force pushing rates up.

3. Another defect in the bill is noted in that it only addresses excess deferrals created by statutory income tax rate decreases. What protection would be afforded to the utilities if the statutory rates were increased by Congress? Would the utility be required to collect rates to fund the higher indicated level of accumulated deferred income taxes if the statutory rates were increased by Congress?

Herein is the sensible solution offered by the ARAM provisions in IRC Section 168. If income tax rates are increased some time in the future, the ratepayers of the utility could be benefited because a "lag" could exist. Simply put, ARAM covers all conditions precipitated by changes in federal income tax rates and treats both the utility and the ratepayer fairly, whereas HR 1049 does not. Thus HR 1049 is not acceptable, fair, just or reasonable and should be rejected.

Thank you for the opportunity to comment.

Very truly yours,



DDH/cr



INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA—UAW

OWEN F. BIEBER, PRESIDENT

RAYMOND E. MAJERUS, SECRETARY TREASURER

VICE PRESIDENTS

BILL CARSTENSEN

DONALD F. EPHLIN

ODESSA KOMER

MARC STEFF

STEPHEN P. YOKICH

December 8, 1987

IN REPLY REFER TO
1757 H STREET, N.W.
WASHINGTON, D.C. 20036
TELEPHONE: (202) 628-8800

The Honorable Charles B. Rangel
Chairman, Subcommittee on Select Revenue Measures
U. S. House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

We understand the Subcommittee on Select Revenue Measures will be conducting a hearing on the proposed "Utility Ratepayer Refund Act of 1987" (H.R. 1049) on December 14, 1987. The UAW supports this legislation, and urges the Subcommittee to give it prompt, favorable consideration.

Under the provisions of the Internal Revenue Code, utility companies are permitted to collect money from consumers to pay for tax liabilities that will be owed by the companies in the future to the federal government. These monies are referred to as "deferred taxes." As a result of the Tax Reform Act of 1986, which reduced the corporate income tax rate from 46 to 34 percent, utility companies have effectively overcharged consumers because their future tax liabilities will be less than was previously anticipated. Utility companies have collected approximately \$19 billion in "excess deferred taxes," which must now be refunded to their customers.

Section 203(e) of the Tax Reform Act of 1986 specifies that any refund of excess deferred taxes must be "normalized" — that is, spread out over the life of the utility company's investment, which can be as long as thirty years. This provision precludes the state regulatory agencies from determining the most appropriate manner of refunding the excess deferred taxes. It also provides little relief to consumers, who may have to wait a long time to get their money back.

The proposed "Utility Ratepayer Refund Act of 1987" (H.R. 1049), which was introduced by Representative Dorgan, would correct this situation by repealing Section 203(e) of the Tax Reform Act. This would enable the state regulatory agencies to determine the most appropriate repayment schedule on a case by case basis, balancing the needs of consumers against the financial status of the utility companies.

The UAW supports the approach embodied in H.R. 1049. In our judgment, it would protect the interests of consumers, while at the same time giving the states sufficient flexibility to deal with their particular situations.

The UAW therefore urges the Subcommittee to give favorable consideration to the proposed "Utility Ratepayer Refund Act" (H.R. 1049). We would appreciate if you would include this letter as part of the hearing record on this legislation.

Sincerely,

Dick Warden
Legislative Director

DW:njk
opeu494

TESTIMONY OF
NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

The National Telephone Cooperative Association (NTCA) is a national trade association representing over 450 small independent cooperative and commercial telephone systems serving rural customers in more than 40 states. On the average, our member systems provide telephone service to areas with an overall density of 5 customers per mile of telephone line. Half of our members are commercial companies and a small percentage of our cooperative member systems are taxable and would be affected by H.R. 1049.

We would like to submit testimony regarding the deleterious impact H.R. 1049, the Utility Ratepayer Refund Act of 1987, would have on small subscribers of commercial telephone systems serving vast agricultural and rural areas.

CURRENT LAW

The Tax Reform Act of 1986 lowers the maximum corporate income tax rate from 46 percent to 34 percent. Because of the lower corporate rate, many telephone systems have accumulated excess deferred income tax reserves. This will occur because income tax deferrals to the reserve accounts have been built up in the past at the 46 percent corporate tax rate. The reduction of the deferred tax reserve will occur in future years at the 34 percent rate. This results in an excess balance in the reserve account.

Congress recognized this and therefore included special normalization requirements for the excess deferred taxes resulting from the lower corporate tax rate. After hearing testimony from industry representatives and consumer groups, Congress determined that normalization is the appropriate method for utilities to return the excess funds in the reserve accounts to ratepayers.

Normalization takes into account the timing difference between when a telephone company uses depreciation for income tax purposes and when deductions are accounted for in terms of the regulatory ratemaking process. Accelerated depreciation for tax purposes lowers the amount of taxes paid on property in the earlier years of its life. For accounting purposes, depreciation, which is allowed by regulators to recover investment expenses, is calculated on a straight-line basis. In the later years, tax and accounting schedules reverse and the tax liability is greater. Under normalization, depreciation is allocated to ratepayers on a straight-line basis and the utility recovers a set amount of taxes from new and future customers over the life of the asset.

The deferred tax reserve reflects the tax collected due to the timing difference between regulatory and tax depreciation. Ratepayers receive credit for the reduced liability, created by the reduction in the corporate tax rate, over the remaining life of the asset.

The Tax Reform Act specified that the excess deferred tax reserve should be reduced over the remaining regulatory lives of the property that gave rise to the reserve for deferred taxes. Under this method, the excess deferred tax reserve is reduced as the timing differences (i.e., differences between tax depreciation and regulatory depreciation with respect to each asset or group of assets in the case of vintage accounts) reverse over the life of the asset. The reversal of timing differences generally occurs when the amount of the tax depreciation taken with respect to an asset is less than the amount of the regulatory depreciation taken (See P.L. 99-514, 99th Congress).

The excess deferred taxes resulting from the lower corporate rate must be accounted for in a way that reduces the excess rate no faster than the average rate assumption method.

The average rate assumption method computes additions to a deferred tax reserve at the effective tax rate for each year until the year in which the accelerated depreciation claimed for tax purposes is less than the amount of the annual straight-line depreciation taken for book purposes.

After this year and for the remaining years in the life of the asset, the deferred tax reserve is reduced ratably using weighted average of the effective tax rates for the years before the timing reversal. At the end of the straight-line life of the asset, the telephone system's tax reserve is reduced to zero.

If a telephone system flows through the excess deferred tax reserves more rapidly than outlined by the average rate assumption method, the normalization requirements are violated and the system loses the ability to take advantage of accelerated depreciation.

CONGRESSIONAL INTENT REGARDING NORMALIZATION

Historically, Congressional intent relating the normalization accounting for telephone companies has been to provide regulated utilities with incentives for acquiring capital assets and to ensure that tax savings which were derived from accelerated depreciation would be available to finance capital investments. The normalization requirements also provide for equitable rate determination. Through normalization accounting, current and future ratepayers benefit from capital incentives in the tax code, such as accelerated depreciation, over time because it adds capital at no cost.

Congress recognized that it was important to ensure that tax benefits intended in the tax code are realized by the regulated utility. Flow through treatment of the excess tax reserve is inconsistent with congressional intent because the tax savings which arise due to accelerated depreciation are used to reduce rates charged to subscribers rather than being used as an internal source of revenue to finance capital assets. If the rural telephone companies were required to flow through the excess deferred taxes which resulted from the lowered corporate tax rate, they would have to refinance their capital that is currently financed by the deferred tax reserve.

BENEFITS OF NORMALIZATION TO RURAL RATEPAYERS

o Longterm Rate Are Lower Under Normalization

If H.R. 1049 were enacted, and state utility commissions required immediate flow through of the excess deferred tax reserve, our rural subscribers may receive an initial rate reduction in year one. However, in the following years, a rate increase would occur because the intended tax benefits that would have been available under normalization would be required to be used for immediate rate reduction. The rates would be increased because the flow through of the excess reserve would have to be factored in the rate determination. This would result in current customers benefiting at the expense of future customers.

The following examples illustrate the impact of the tax rate reduction with respect to deferred income taxes under current law and under H.R. 1049. We have assumed a 7-year remaining life for the associated assets and equal amounts returned annually for this illustration. We also have assumed a 10% rate of return and 34% federal income tax rate. Revenue requirements would be directly reduced by the amount of excess normalization taken into income each year. Since the rate base is reduced by deferred taxes, the amount returned to income must be added back to the rate base. The return and tax allowances computed on the increased rate base is then subtracted from the normalized excess to determine the impact on the ratepayer.

CURRENT LAW NORMALIZATION REQUIREMENTS

	Amount Flowed Back to Ratepayer	Accumulated Increase in Rate Base	Return on Rate Base + Taxes	Net Benefit to Ratepayer
	(1)	(2)	(3)	(1)-(3)
Year 1	\$100,000	\$100,000	\$ 15,000	\$85,000
Year 2	120,000	220,000	33,000	87,000
Year 3	140,000	360,000	54,000	86,000
Year 4	160,000	520,000	78,000	82,000
Year 5	180,000	700,000	105,000	75,000
Year 6	200,000	900,000	135,000	65,000
Year 7	220,000	1,120,000	168,000	65,000
Total Net Benefit to Ratepayer				\$532,000
Net Present Value at 8%				\$404,180

The following example illustrates that under H. R. 1049, ratepayers would be penalized over the long run if commissions are allowed to flow through the excess accumulated deferred taxes. Using the same assumptions as in the previous model, we show the impact of normalization repeal:

	Excess Flowed Through	Increase in Rate Base	Rate on Rate Base + Taxes	Net Impact on Ratepayer
Year 1	\$1,120,000	\$1,120,000	\$168,000	\$952,000
Year 2		1,120,000	168,000	(168,000)
Year 3		1,120,000	168,000	(168,000)
Year 4		1,120,000	168,000	(168,000)
Year 5		1,120,000	168,000	(168,000)
Year 6		1,120,000	168,000	(168,000)
Year 7		1,120,000	168,000	(168,000)
Total Net Increase to Ratepayer				(56,000)
Net Present Value 8%				162,367

The net result is that ratepayers save approximately \$532,000 under normalization but would pay \$56,000 more by using immediate flow through; or a total difference of \$588,000. When the time value of money is considered, flow through penalizes ratepayers by \$241,813. (The charts are based on estimates reflecting a telephone system with 25,000 access lines).

From our perspective, any change in the present tax law would not be in the best interest of our customers.

The per subscriber capital requirements of rural telephone systems are relatively greater than that of systems serving urban areas. Because the areas rural telephone systems serve have an average of only 5 customers per mile of telephone line (as opposed to 50 per mile for all telephone companies and 130 per mile for Bell Operating Companies) it is generally most costly to provide telephone service. In some areas, our members serve less than .6 customers per mile of telephone line.

The introduction of competition and deregulation of the telephone industry have brought about several major policy shifts which could reverse or diminish historical revenue and net income growth trends. The phaseout of settlements at the state level, competition for service to selected customers and the shift in allocation and recovery of costs can provide less revenue for local telephone companies.

NTCA members rely on the Rural Electrification Administration and the Rural Telephone Bank for capital financing. Most REA borrowers cannot afford to pay commercial interest rates. REA borrowers have an average ratio of net worth to total assets of 30%, far below the 50-60% required by commercial lending institutions. One fourth of these systems have less than 1,000 subscribers and one-half have less than 2,000.

Normalization provides for the retention of deferred reserves which are then used as a very important internal source of capital funding -- as was intended by Congress. The excess deferred tax reserve is not cash in the bank, but rather is used by the telephone system to invest in capital equipment. Our average member system has invested more than \$2,000 per customer in total telephone plant. Without this source of funding, rural telephone systems would have to rely on more expensive, external source of financing necessary to refinance these capital expenditures. These costs would then be passed on to the rural subscriber.

The loss of the internal capital financing source would increase the rural telephone system's reliance on the REA loan program. The Administration is seeking to hasten the termination of telephone loans from the Rural Electrification Administration.

One goal of the Rural Electrification Administration Rural Telephone Bank is to provide small, rural telephone systems with affordable financing to enable them to achieve financial self-sufficiency. To repeal normalization would create inconsistent federal policy where federally provided capital financing is more difficult to obtain and tax policy drains the rural telephone system of badly needed capital. This would hinder the ability of rural telcos to achieve self-sufficiency.

CONCLUSION

The National Telephone Cooperative Association opposes the Utility Ratepayer Refund Act because of the negative impact it will have on our members customers.

Congress made the decision to normalize excess deferred tax reserves of regulated utilities after much deliberation. Normalization is recognized as the most efficient and equitable method to return the reserves to ratepayers.

Repeal of normalization is not in the best interest of rural subscribers. While subscribers may experience a reduction in rate initially, they would see their rates increase above their current level over the long term. H.R. 1049 would impose an undue economic burden to rural ratepayers residing in economically depressed areas.

If the legislation were enacted, rural telephone systems' would lose an important source of capital financing and would be more reliant on the beleaguered REA loan program. Not only would rural telephone systems have to look to more expensive sources of revenue, rural ratepayers would bear the brunt of the burden through increased rates.

We ask that the committee consider the special circumstances affecting rural telephone systems when they consider legislation to repeal normalization.

New York City
Energy and Telecommunications Office

Submitted By

Ruth J. Morrison

Telecommunications Policy Analyst

The City of New York
Position Statement
On H.R. 1049

The New York City Energy and Telecommunications Office (ENERTEL) represents New York City residents, businesses and government in a wide variety of energy and telecommunications proceedings in various forums, private and public, and before the New York State Public Service Commission (PSC or Commission). ENERTEL is a co-sponsor with the New York State Office of Economic Development (formerly the Department of Commerce) and the New York State Science and Technology Foundation of a study on the telecommunications environment in New York State and chief architect of the "New York City Program for Competitive Business Energy Costs." ENERTEL also conducts policy analyses and provides recommendations on energy and telecommunications issues to the City's state and federal legislative representatives.

The City of New York, acting through the New York City Energy and Telecommunications Office, (hereinafter "the City") is giving its support to H.R. 1049, the "Utility Ratepayer Refund Act of 1987", introduced by Rep. Byron Dorgan, D-N.D.

H.R. 1049, or the Dorgan Bill as it is commonly referenced, would repeal Section 203(e) of the 1986 Tax Reform Act. At present, utilities are allowed to collect deferred taxes from their customers - that is taxes are collected for future federal tax liabilities.

The Tax Reform Act of 1986 ("TRA") reduced the corporate tax rate from 46% to 34%, thereby giving some utilities an even greater excess of deferred taxes. In addition, the 1986 TRA allows utilities to delay the refund of excess deferred taxes over the entire remaining service life of the assets which originally created the tax deferral, and the delay can be as long as 30 years.

The Dorgan Bill if passed, would allow state utility regulators to speed the refund of excess deferred taxes to consumers. Moreover, it would give state regulatory commissions the flexibility to make these determinations on a case-by-case basis according to the financial health of each individual company and the needs of their customers.

The City believes the authority to determine the flow through of excess deferred taxes should rest with the state utility regulatory commissions. The state commissions are in the best position to determine the appropriate procedures for handling excess deferred taxes.

The City does not believe that H.R. 1049, which seeks only to repeal Section 203(e) of the Tax Reform Act of 1986 and gives jurisdiction for the disposition of deferred taxes to State regulatory agencies, is detrimental to the well being of the utilities. Passage of the Dorgan Bill does not per se require utilities to immediately return deferred taxes to ratepayers but rather gives State Commissions an opportunity to scrutinize the proposals of the utilities relative to the handling of these accruals. In some cases the amount of excess deferred taxes owed to utility customers is quite substantial. According to the New York State Public Service Commission, the amount of excess deferred taxes owed to New York utility customers exceeds \$1 billion.¹

The utilities claim that they do not actually have these funds on hand but rather that deferred taxes represent an "accounting entry" which resulted from their use of accelerated depreciated to reduce taxable income and defer actual payment of some taxes. Deferred taxes were handled on an accrual basis and represent a future liability of the company. Therefore, the utilities maintain that the use of "normalization" accrual accounting methods stimulated capital formation and the benefits flowed to ratepayers. The utilities claim that if required to return the deferred taxes to ratepayers immediately, they would have to borrow the money and, ultimately, the ratepayers would pay for the cost of that borrowing.

¹ See, Peter Bradford, NYS Public Service Commission, "Bradford Urges Congress to Give State Control Over Refund of Utility Federal Tax Windfall", July 13, 1987. 98102/TR

Refunds to ratepayers would not be automatic. Rather, H.R. 1049 would allow state utility regulators to speed the refund of excess deferred taxes to customers only if they deemed it appropriate. But more importantly, it would give state regulatory commissions the flexibility to make these determinations on a case-by-case basis according to the financial health of each individual company and the needs of their customers.

The City of New York recognizes that if Section 203(e) of the 1986 TRA is not repealed, the utilities will receive what is an interest-free loan from their customers.

Based on New York Telephone's 1986 Annual Report to the Federal Communication Commission, in 1986, excess deferred taxes owed to New York Telephone Company customers was over \$500 million.² In addition, according to the U.S. Federal Energy Regulatory Commission, in 1986, excess deferred taxes owed to Consolidated Edison Company of New York customers was more than \$162 million.³

Utility rates in New York are among the highest in the country, therefore, the City of New York is working aggressively for reductions in utility rates, where appropriate. Recently the City announced a Five-Year Program for Competitive Business Energy Costs which -- through a series of state and local tax cuts and aggressive conservation programs -- will provide an average reduction of about 16% in business energy costs compared to current prices and provide an essential competitive boost for major energy users such as manufacturers and the operations centers of financial institutions, insurance companies and the like. Therefore, it is most appropriate that the City of New York supports H.R. 1049. The City believes that it would be inconsistent with its policy to remain silent while New York City utility ratepayers provide zero-interest loans to their utilities.

The City of New York believes that the Dorgan Bill is in the best interest of economic development and of our business and residential communities. The bill deserves our support.

² U.S. Federal Communications Commission, FCC Form M.

³ U.S. Federal Energy Regulatory Commission, FERC Form 1.

THE NORTHERN CALIFORNIA POWER AGENCY
180 KIRBY WAY
ROSEVILLE, CA 95678

December 18, 1987

Mr. Chairman:

The Northern California Power Agency (NCPA) is a joint action agency of thirteen consumer-owned electric utility systems, including the cities of Alameda, Biggs, Gridley, Healdsburg, Lodi, Lompoc, Palo Alto, Redding, Roseville, Santa Clara, Ukiah, the Plumas-Sierra Rural Electric Cooperative, and the Turlock Irrigation District. NCPA represents and assists its members in the purchase, generation, transmission, and distribution of wholesale electricity.

The Northern California Power Agency and the more the 550,000 consumers they represent wishes to thank the Subcommittee for holding the December 14th hearing on H.R. 1049, the Utility Ratepayer Refund Act of 1987. We join the Consumer Federation of America, the National Association of Regulatory Commissioners, Environmental Action and a wide array of major corporations in strong support of this legislation.

The bill addresses a gross inequity in current law under which the nation's private utilities have at their disposal \$19 billion of risk-free capital which rightly belongs to the ratepayers. H.R. 1049 does not mandate a rapid and automatic flow-through of the excess deferred taxes to the ratepayer, but would allow each state's public service commission to determine the most prudent and equitable timetable for returning the ratepayers' money, while taking into consideration the utility's financial situation and the community's long-term economic interest. We are concerned, however, that we, as public wholesale suppliers of electricity, may be caught in a price squeeze unless the Federal Energy Regulatory Commission is required to implement refunds of excess deferred taxes that we have paid the utilities. NCPA respectfully requests that the Subcommittee address this potentially serious problem and would be most happy to provide any information needed.

We thank the Subcommittee for this opportunity to enter this summary testimony for the record.

Respectfully Submitted.

H.R. 2792.—INDIAN FISHING RIGHTS

(BY PERMISSION OF THE CHAIRMAN:)

Incomindios

INCOMINDIOS Schweiz ~~St. Johanns-Vorstadt 51~~ CH-4056 Basel
Postfach CH 4303 Kaiseraugst Switzerland

Zurich, December 1st 1987

Chairman
House Committee on Ways and Means
Dan Rostenkowski

House of Representatives
2111 Rayburn HOB
Washington DC 20515
USA

Very honorable Representative Rostenkowski,

Our organization, INCOMINDIOS, a support organization in Switzerland with about 1100 members, has as its purpose to contribute to the realization of the rights of Indian Peoples in North- and Southamerica. We are very much interested that the treaty rights of Indian Peoples be respected. We think, that the Internal Revenue Service, trying to impose taxes on the Lummi Nation, is violating the treaty rights of this Indian Nation. Therefore we urge you, dear Representative Rostenkowski, to ensure the passing of the Fishing Rights Bill (HR 2792) and to help to protect the Lummi Nation from taxation by the Internal Revenue Service.

We thank you in the name of the members of INCOMINDIOS for your concern.

Yours sincerely,

J. Maillard

Josy Maillard
Member of the Board

A. Frauenfelder

Arnold Frauenfelder
Member of the Board

Copy to Jewell Praying Wolf James, Coordinator Lummi Treaty Protection Task Force, 2616 Kwina Road, Bellingham, 98226 Washington.



INDIAN TREATY RIGHTS COMMITTEE

Suite 2418 • 59 E. Van Buren • Chicago, Illinois 60605 • (312) 899-1800/1820 or 663-5396

December 11, 1987

To: Subcommittee on Select Revenue Measures
U.S. House of Representatives
The Honorable Charles B. Rangel, Chairperson
Washington, D.C. 20515

From: Indian Treaty Rights Committee
59 East Van Buren
Chicago, IL 60605
(312) 899-1800 or 663-5396

Re: Indian Fishing Rights Bill (HR 2792)

Representing numerous and a variety of Chicago based coalition of religious and civic organizations (as partially listed below), we support HR 2792, a bill "To clarify Indian treaties, Executive Orders, and Acts of Congress with respect to Indian fishing rights." We urge favorable reporting of this bill without amendment by the Subcommittee on Select Revenue Measures. We join Indian tribes, numerous human rights organizations and religious groups in support of this bill which is in keeping with the rights guaranteed American Indians through treaties with the U.S. government dating back to over a century.

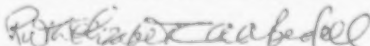
To require payment of taxes on income derived from fishing within the treaty designated areas, as the Internal Revenue Service is attempting with respect to Lummi Indians in the Northwest, is a violation of guaranteed rights. The right to fish has been traditionally interpreted as being not only for subsistence but also for commercial purposes as well. There is no dispute over tax on fish caught outside of treaty designated waters, which, it is agreed, is taxable.

HR 2792 embraces the principle of respect for treaties negotiated between the tribes and the U.S. government. In fishing rights cases adjudicated by the Courts, the rulings have been consistent that fishing rights are retained by tribes in treaties "at all usual and accustomed grounds and stations" and that any income thus derived by tribal members are not taxable.

Any tax revenue garnered from the tribe's fishing will be very small in federal government terms but will be a severe blow to the economy of the tribe and possible survival of their culture, which we believe to be integral to U.S. society. We believe that HR 2792 will serve to protect fishing and hunting rights of all Indian tribes from future encroachment of their rights.

This legislation is particularly crucial in guaranteeing that the U.S. government will continue to honor the treaties which have been signed with American Indian tribes. It is important for our foreign policy's integrity that we honor all treaties.

We urge your favorable consideration of this Indian Fishing Rights Bill.


Submitted by Ruth Bedell
for the Indian Treaty Rights Committee
Chicago, Illinois

Rev. Joseph E. Agne (Northern Illinois Conference of United Methodists) • Rev. David Whitmore, Exec. Dir. (Church Federation of Greater Chicago) • Rev. Martha D'Aquila (United Methodist Church, Racial Justice Working Group) • Mary D. Powers (Coventry) (Citizens Alert) • Faith Smith, President (Native American Educational Services College) • Shirley Canchola (National Indian Lutheran Board) • Joy Yamashiki (Japanese American Citizens League - Chicago) • Rev. S. Michael Yasutake (Episcopal Priest, Midwest Network, National Council Churches, Racial Justice Working Group) • Joe White Eyes, Faculty (Native American Educational Services College) • Ruth Bedell (Clergy & Laity Concerned) • Rev. Willie Barrow (Operation PUSH) • Phillip John (Chicago Urban League) • Rev. Rollins E. Lambert, (Director, Office of Human Rights, Archdiocese of Chicago) • Sharon Taylor (U. A. S. College) • Rev. John D. Sturman, (Chicago Disciples Union) • James Yellowbank, Cherly Sigsbee, (Big Mountain Support Group) • Nephale Wolf. (Affiliation for identification only.)

GERRY SIKORSKI

8th DISTRICT, Minnesota

WHIP AT LARGE

ENERGY AND COMMERCE

POST OFFICE AND CIVIL SERVICE

CHAIRMAN, HUMAN RESOURCES

SELECT COMMITTEE ON
CHILDREN, YOUTH, AND FAMILIES

Congress of the United States
House of Representatives
 Washington, DC 20515

December 23, 1987

WASHINGTON OFFICE:
 414 CANNON HOUSE OFFICE BLDG.
 WASHINGTON, DC 20515
 (202) 225-2271
 DENNIS McGRATH
 ADMINISTRATIVE ASSISTANT

DISTRICT OFFICE:
 5080 UNIVERSITY AVENUE NE
 FRIDLEY, MN 55432-1882
 (612) 780-8801
 DAVID BARTHOLOMEW
 DISTRICT DIRECTOR

Honorable Charles Rangel
 Chairman
 Subcommittee on Select Revenue Measures
 Committee on Ways and Means
 1136 Longworth House Office Building
 Washington, D.C. 20515

Dear Chairman Rangel:

We are writing as cosponsors of H.R. 2792 to urge the Subcommittee to promptly favorably report this vital Indian measure to the full Committee.

From your hard work and your December 14 Subcommittee hearing, you know that this measure clarifies the non-taxable status of income derived by Indian people in the exercise of their treaty-secured fishing rights. The Internal Revenue Service's unprecedented move to impose the Federal income tax on such income of Indians in the Pacific Northwest and Great Lakes occurred decades after treaties, Executive Orders and Acts of Congress secured Indian hunting and fishing rights.

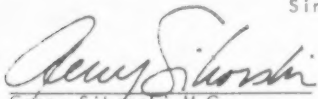
Clearly, the Indian leaders who were signatories to legal documents that preserved their aboriginal hunting and fishing rights in exchange for the cession of vast areas of their tribal homelands believed that they had struck a lasting bargain with the United States, and that their valuable rights would never be diminished in the future.

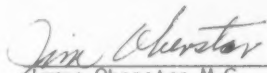
However, in recent years the IRS adopted a position that, absent a specific exemption in the treaties or Acts of Congress, treaty fishing income was indeed subject to Federal income tax. Notwithstanding the Department of the Interior's strong and persuasive legal arguments upholding the non-taxable status of treaty fishing income, the Department of Justice Office of Legal Counsel issued an opinion on December 12, 1985, supporting the IRS policy views on this matter. Unfortunately, the IRS then intensified its efforts to tax treaty fishing income.

Mr. Chairman, the long course of Federal-Indian relations is replete with broken promises by the government of the United States. These broken promises have in large measure contributed to the loss of the Indians' valuable land and resources. While America has prospered from such land and resources, the Indians have been subjected to abject poverty and discrimination. The Congress has a real opportunity to partly redress this unfortunate record by promptly enacting H.R. 2792 into law.

In conclusion, we wish to emphasize that this measure does not establish a new exemption in the tax code, but clarifies the non-taxable status of Indian fishing income pursuant to the rights established in treaties, Executive Orders and Acts of Congress. We request that our letter be included in the printed hearing record on H.R. 2792.

Sincerely,


Gerry Sikorski M.C.


James Oberstar M.C.

cc: Hartley White, Chairman
Leech Lake Band of Chippewa

Darrell Wadena, Chairman
White Earth Band of Chippewa

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